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No. 15362

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

WILLIAM ERNEST HOFFMAN,

*Appellant,*

*vs.*

UNITED STATES OF AMERICA,

*Appellee.*

---

## BRIEF OF APPELLEE.

---

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No. 15362

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

WILLIAM ERNEST HOFFMAN,

*Appellant,*

*vs.*

UNITED STATES OF AMERICA,

*Appellee.*

---

## BRIEF OF APPELLEE.

---

### Jurisdiction.

The jurisdiction of the District Court in this case arose under Title 18, U. S. C., Section 495, June 25, 1948, Chapter 645, 62 Stats. 711, and Title 18, U. S. C. A., Section 3231, June 25, 1948, Chapter 645, 62 Stats. 826.

The jurisdiction of this Court was invoked under the provisions of Title 28, U. S. C. A., Section 1291, June 25, 1948, Chapter 646, 62 Stats. 929, and Rules 37 and 39 of the Federal Rules of Criminal Procedure, Title 18, U. S. C. A., as amended December 27, 1948, effective January 1, 1948.

### Statement of Case.

On May 20, 1955, appellant was indicted on seven counts of forgery of a Government check in violation of Title 18, U. S. C. A., Section 495. Section 495 provides:

“Whoever falsely makes, alters, forges, or counterfeits any deed, power of attorney, order certificate, receipt, contract, or other writing, for the purpose of obtaining or receiving, or of enabling any other person, either directly or indirectly, to obtain or receive from the United States or any officers or agents thereof, any sum of money; or

“Whoever utters or publishes as true any such false, forged, altered, or counterfeited writing, with intent to defraud the United States, knowing the same to be false, altered, forged, or counterfeited; or

“Whoever transmits to, or presents at any office or officer of the United States, any such writing in support of, or in relation to, any account or claim, with intent to defraud the United States, knowing the same to be false, altered, forged, or counterfeited—

“Shall be fined not more than \$1,000 or imprisoned not more than ten years, or both. June 25, 1948, c. 645, 62 Stat. 711.”

Following a trial by jury on his plea of not guilty appellant was found guilty on six counts of the indictment. Count III was dismissed. Sentence was imposed by the Court at five years on Count I; and two and one-half years on Count II to run consecutively with the five



years imposed on Count I; and five years on each of Counts IV, V, and VI to run concurrently with each other and concurrently with the period on Count I, making a total of seven and one-half years' imprisonment. Imposition of sentence on Count VII was suspended for the period of five years and the appellant was placed on probation for this period. Said period of probation was made to commence at the expiration of the periods of imprisonment on Counts I, II, IV, V and VI. At the trial below appellant Hoffman was represented by his retained counsel, Richard E. Erwin, Esq. No appeal was taken from the Judgment of Conviction, but on September 7, 1956, appellant filed in the Court below a motion under 28 U. S. C. A., Section 2255, to correct his sentence received on the above-mentioned Judgment of Conviction. This motion was denied by the Honorable Ben Harrison on September 10, 1956. The instant appeal was taken from said order of denial.

## ARGUMENT.

Although appellant was represented on trial by retained counsel he prosecutes this appeal *in propria persona*. Bearing in mind the admonition of the Supreme Court that judicial liberality be exercised in considering the petitions of such persons, *Tompkins v. Missouri*, 322 U. S. 485, 487; *Darr v. Burford* (1949), 339 U. S. 200, 203; *Thomas v. Tietz* (1953, 9th Cir.), 205 F. 2d 236, it is still submitted that appellant by his brief herein shows no cause for relief and the order appealed from accordingly should be affirmed.

### Proceedings Under 28 U. S. C. A., Section 2255, May Not Be Used to Relitigate Issues Properly Raised by Appeal.

As heretofore stated, appellant Hoffman took no appeal from his Judgment of Conviction. The instant appeal is taken from the denial of his Motion to Correct Sentence under 28 U. S. C. A., Section 2255. Regardless of the caption it is apparent that by this appeal, appellant seeks to have determined issues which are properly cognizable only by an appeal on the merits of the case. Thus referring to his trial below appellant states (Br. 6):

“On or about the 12th day of September, 1955, after a plea of not guilty the defendant/appellant was placed upon his trial and found guilty by a jury on all counts. *It was during and throughout this said trial that the herein stated, errors, violations and denial of those rights secured to the appellant by the Constitution of the United States were violated.*”

Patently appellant seeks review of the questions going to the merits of his case arising out of the trial of the case itself and depending largely upon determination of factual

matters. Illustrative is appellant's attempt (Br. 7) to digest the evidence adduced at the *trial* of his case and predicate a considerable portion of his argument upon it. Inasmuch as this appeal is from a denial of a motion under Section 2255 (*supra*) such attempt runs afoul of the settled rule that a motion under 28 U. S. C. A., Section 2255, may not be used to secure a review of questions properly raised by appeal on the merits of the case. Controlling in this regard is the succinct opinion of this Court in *Hastings, et al. v. United States* (1950, 9th Cir.), 184 F. 2d 939, hereinafter set out in full, viz.:

PER CURIAM. "This is an appeal from a judgment in a proceeding under 28 U. S. C. A. 2255, denying appellant's motion to vacate a judgment sentencing them to a confinement for two years for the possession of a sawed-off shotgun, a 'firearm' which had not been registered, in violation of 26 U. S. C. A. 3261: The ground of the motion as urged here is that the verdict of guilty is without evidence to support it and that the trial judge gave an erroneous instruction. *There was no appeal from the judgment of conviction and what appellants seek in this Sec. 2255 proceeding is a retrial of their case.*

"A proceeding under section 2255 is intended as a substitute for habeas corpus. The contentions here urged would not be considered in a habeas corpus proceeding. We agree with the opinion of the Fourth Circuit in *Taylor v. United States*, 4 Cir., 177 F. 2d 194, which states at page 195, 'Prisoners adjudged guilty of crime should understand that 28 U. S. C. A., Sec. 2255, does not give them the right to try over again the cases in which they have been adjudged guilty. Questions as to the sufficiency of the evidence or involving errors either of law or of fact must be raised by timely appeal from the sentence, if the petitioner desires to raise them. Only where

the sentence is void or otherwise subject to collateral attack may the attack be made by motion under 28 U. S. C. A., Sec. 2255, which was enacted to take the place of habeas corpus in such cases and was intended to confer no broader right of attack than might have been made in its absence by habeas corpus.'

"The judgment is affirmed." (Emphasis added.)

Inasmuch as appellant was represented below by retained counsel the language of the Fourth Circuit in the recent case of *Banghart v. United States* (1953), 208 F. 2d 902, is pertinent, to wit:

"It appears, however, that none of the questions which he now seeks to raise were raised upon the trial or by appeal, although appellant was represented by able counsel of his own choosing and there is no suggestion that counsel did not faithfully represent his interests. A motion under 28 U. S. C. A., Sec. 2255, is proper only where the judgment under which a prisoner is confined is subject to collateral attack. It may not be used in lieu of appeal to review questions which were raised *or should have been raised upon the trial.*" (Emphasis added.)

The Tenth Circuit discussed the nature of the remedy in *Hearst v. United States* (1949, 10th Cir.), 177 F. 2d 894, 895, where speaking of Section 2255 (*supra*), the Court stated:

"That section does not give a prisoner the right to obtain a review, first by the court which imposed the sentence and then on appeal from a denial of a motion to vacate, of errors of fact or law that must be raised by timely appeal. It does not enlarge the class of attacks which may be made upon a judgment of conviction, but provides that the attack must be made in the court where the sentence was imposed



and not in some other court through resort to habeas corpus, unless it appears that the remedy by motion is inadequate. It is limited to matters that may be raised by collateral attack. It is only where the judgment was rendered without jurisdiction, the sentence imposed was not authorized by law, or there was such a denial or infringement of the Constitutional rights of the prisoner as to render the judgment vulnerable to collateral attack that a motion to vacate will lie under such section.

“Errors in admission of evidence must be raised by appeal and do not constitute a basis for collateral attack.”

See also:

*Hill v. United States* (1955, 6th Cir.), 223 F. 2d 699;

*Davis v. United States* (1954, 7th Cir.), 214 F. 2d 594;

*United States v. Rutkin* (1954, 3rd Cir.), 212 F. 2d 641;

*Roper v. United States* (1954, 4th Cir.), 212 F. 2d 783;

*United States v. Spadafora* (1953, 7th Cir.), 207 F. 2d 291;

*Klein v. United States* (1953, 7th Cir.), 204 F. 2d 513;

*Hilliard v. United States* (1950, 4th Cir.), 185 F. 2d 454;

*Goss v. United States* (1949, 6th Cir.), 179 F. 2d 706;

*Storey v. United States* (1949, 8th Cir.), 174 F. 2d 120.

On the basis of the foregoing authority, it is submitted that appellant's attempt to retry the issues in the case by way of a motion under Section 2255 should be denied.

## Appellant's Allegations Are Not Supported by the Record.

Appellant's chronicle of the evidence at his *trial* (Br. 7) is subject to the further objection that it is not supported by the record docketed with this Honorable Court. The Designation of the Record on Appeal [Clk. Tr. 43] filed in the Court below, nowhere makes provision for the inclusion of any Reporter's Transcript of the proceedings on trial. This, and other, Courts of Appeals have uniformly held that the sufficiency of the evidence in the Court below cannot be questioned in absence of a proper transcript of the proceedings. This requirement is succinctly stated by the Seventh Circuit in *In re Chapman Coal Co.* (1952, 7th Cir.), 196 F. 2d 779, 785:

“Where, as in this case, there has been a hearing in the District Court in which the parties have participated by their attorneys, where evidence has been heard, and where the District Court has entered an order which would be justified by the evidence which might have been adduced or agreements which might have been made between the parties in such hearing, the burden is upon the party appealing from such an order to include in the record on appeal a proper transcript of the hearing to show that there was no such evidence or agreement. All possible presumptions are indulged to sustain the action of the trial court. It is, therefore, elementary that an appellant seeking reversal of an order entered by the trial court must furnish to the appellate court a sufficient record to positively show the alleged error. *Turner Glass Corp. v. Hartford Empire Corp.*, 7 Cir., 173 F. 2d 49, 51; *Royal Petroleum Corp. v. Smith*, 2 Cir., 127 F. 2d 841, 843; 12 Cyc. of Federal Procedure, 2nd Ed. 1944, Sec. 6208, p. 224 *et seq.*”

As this Court recently said in *Jernigan v. Southern Pacific Co.* (1944, 9th Cir.), 222 F. 2d 245, 248:

“Nor can we question the sufficiency of the evidence which resulted in the order below. Since the burden of showing grounds on which a judgment should be reversed rests upon the appellant, and the evidence not being here, the appropriateness of the validity of the evidence to support the order and the judgment cannot now be questioned.”

See also the extensive compilation of authority contained in Note 6, page 248 of the *Jernigan* opinion. It is abundantly clear that it is the duty of the appellant to furnish this Honorable Court with a sufficient and proper record and to show with particularity wherein claimed error has been committed. This he has failed to do. Nor can he properly do so inasmuch as the issues which he would allegedly raise are improper in a collateral appeal such as is involved under Section 2255 (*supra*).

### **Appellant Was Not Prejudiced by the Actions of the Court and Prosecutor.**

Correlative perhaps, to the appellant's failure to designate and present to this Honorable Court, a proper record, is his failure to state beyond bare allegations in what way he was prejudiced by actions of Court and counsel. It is provided in Rule 52 of the Federal Rules of Criminal Procedure, 18 U. S. C. A.:

“(a) Harmless error. Any error, defect, irregularity or variance which does not affect substantial rights shall be disregarded.”

It is settled the burden of demonstrating error is upon an appellant.

*Myers v. United States* (1949, 8th Cir.), 174 F. 2d 329;

*Kimball Laundry Co. v. United States* (1948, 8th Cir.), 166 F. 2d 856.

It is established contrary to appellant's contentions that a reviewing court indulges all presumptions in favor of the validity of the trial court's order. Prejudicial error will not be presumed, it must be specifically and affirmatively shown. This appellant has failed to show in what way he was prejudiced by the actions of Court and counsel. Lacking a transcript we have only his bare allegations that certain prejudicial statements were made. Even in this he indulges in conclusions, viz. (Br. 7):

"When the defendant/appellant was on the stand the prosecution for the Government set forth an attack upon the defendant's past record making him admit his previous conviction for the State of California for the charge of forgery as well as other arrests that the defendant has been arrested for, although he has proven his innocence to the charges. The prosecution brought forth the fact that the defendant/appellants girl friend had been convicted for a charge of Forgery by the State of California and was at the time serving a sentence and the the defendant/appellant had assisted in her defense. The Court itself asked at that time if the defendant/appellant would have assisted her if he would have thought her guilty."

In absence of a transcript it is impossible to find error on the basis of appellant's conclusions. Accordingly, it is submitted that appellant's assertion of prejudice must fall in absence of substantiation.

**Appellant Was Properly Tried, Convicted and Sentenced for a Violation of 18 U. S. C. A., Section 495.**

In reliance of certain archaic authority (*Wilson v. United States*, 16732 Fed. Cases) appellant urges that he was improperly convicted under Section 495, Title 18, U. S. C. A.

The argument is made that checks cannot fall under the "other writings" provision used in this section. This contention has been determined adversely to appellant's view in *Prussian v. United States* (1931), 282 U. S. 675, 679, wherein it was stated:

"But we think the indictment is to be sustained as charging an offense under section 29 of the Criminal Code, which punishes the forgery of 'any deed, power of attorney, order, certificate, receipt, contract, or other writing, for the purpose of obtaining or receiving . . . from the United States, or any of their officers or agents, any sum of money.' The indictment alleges specifically and with certainty the forgery of the endorsement on the draft, for the purpose of obtaining a sum of money from the Treasurer of the United States, and charges a violation of section 29. We think the endorsement was a 'writing' within that section. Its language is 'comprehensive' and all 'embracing'. Cf. *United States v. Davis*, 231 U. S. 183, 188. The writings enumerated have no common characteristic from which a purpose may be inferred to restrict the statute to any particular class of writings. The addition of 'other writing' to the enumeration was therefore not for the purpose of including writings of a limited class, but rather of extending the penal provisions of the statute to all writings of every class if forged for the purpose of obtaining money from an officer of the



United States. . . . It has been generally assumed by the lower federal courts that Section 29 covers the forging of an endorsement. . . .”

See also:

*Conklin v. Cozarts*, 158 F. 2d 676, cert. den. 322 U. S. 801.

Appellant seeks to make the distinction between “pension type checks” and “allotment type checks” (Br. 8). This problem has been touched by this Honorable Court in *DeMaurez v. Squier* (1944, 9th Cir.), 144 F. 2d 564, wherein Judge Stephens shows the basic problem to be the difference between the penalties provided in 18 U. S. C. A., Section 495 (formerly 18 U. S. C. A., Sec. 73) and 38 U. S. C. A., Section 128. This latter section is a specific section dealing with the forgery of endorsement of pension checks and providing a penalty therefor of lesser amount than that contained in the general provisions of 18 U. S. C. A., Section 495. In 38 U. S. C. A., Section 128, it is provided:

“Whoever shall forge the endorsement of the person to whose order any pension check shall be drawn, or whoever with the knowledge that such endorsement is forged shall utter such check, or whoever, by falsely personating such person, shall receive from any person, firm, corporation, or officer or employee of the United States the whole or any portion of the amount represented by such check, shall upon conviction be punished by a fine of not more than \$1,000, or be imprisoned not more than five years, or both. August 17, 1912, c. 301, Sec. 4, 37 Stat. 313.”

Appellant in his argument (Br. 8) attacks only Counts I, IV, V and VI. Count I involves a check which is labeled “compensation.” Counts IV, V and VI involve

social security checks. However, it is unnecessary to reach the problem of whether compensation checks and social security checks are to be considered pension checks within the purview of 38 U. S. C. A., Section 128, or other writings under the provisions of 18 U. S. C. A., Section 495. As heretofore stated, appellant was sentenced to five years on Count I; two and one-half years on Count II consecutive with Count I; and five years on Counts IV, V and VI concurrent with Count I. Inasmuch as sentences of five years could have been imposed by the Court under Section 128 (*supra*), appellant sentenced to a lesser period may not complain. Controlling is the case of *DeMaurez v. Squier* (1941, 9th Cir.), 121 F. 2d 960, wherein Judge Wilbur stated at page 961:

“Whether or not the check in question was a pension check or a writing coming within the provisions of the earlier Act 18 U. S. C. A., Section 73, *supra*, cannot properly be considered by this court upon this application for writ of habeas corpus for the reason that in either view the cumulative sentence imposed upon the petitioner is for a term of ten years. Until the petitioner has served that term he cannot seek release by habeas corpus on theory that the cumulative sentence of 15 years was excessive and void as to the first count.”

Likewise in the instant case even assuming conviction to be had under the lesser provision of Section 128, sentences of five years on each Count could have been imposed. Regardless of under what section sentence was actually made a cumulative sentence was still within the bounds permitted the Court by the lesser statute. Accordingly, appellant cannot be prejudiced thereby.

### Conclusion.

Although appellant ostensibly seeks to appeal from an order denying his petition under 28 U. S. C. A., Section 2255, it is submitted that in actuality he is wrongfully attempting to secure a review of the merits of his case properly presented only by appeal. Appellant has made allegations unsupported by the record in that he has failed to include a transcript to support certain statements which he claims were made. He has thereby failed in his duty as an appellant to present to the Court of Appeals a record in which alleged errors are clearly designated. In any event the cumulative sentence imposed upon the appellant is less than the amount which could have been imposed under the provisions of the lesser statute governing pension checks. Accordingly, it is submitted that this Honorable Court deny appellant's appeal and affirm the order of Judge Harrison.

Respectfully submitted,

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*Attorneys for Appellee.*



No. 15303

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

MILDRED MARIE YOUNG, individually and DANNY LEE YOUNG, DAVID RAY YOUNG and DANIEL RAY YOUNG, through their guardian *ad litem*, Mildred Marie Young,  
*Appellants,*

*vs.*

AEROIL PRODUCTS COMPANY INC., a corporation, STRUCTURAL MATERIAL COMPANY, a corporation and DERYL S. YUNDT,

*Appellees.*

---

Appeal From the United States District Court for the Southern District of California, Central Division.

---

## APPELLANTS' OPENING BRIEF.

---

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FILED

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PAUL R. O'BRIEN, Clerk



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### I.

The court erred in giving judgment for defendants by concluding from the evidence that the plaintiffs as a matter of law did not prove a cause of action against defendants and that as a matter of law the plaintiffs were required to prove a cause of action for either warranty, or negligence, or deceit because it is one cause of action being a hybrid of contract and tort, and in concluding as a matter of law there were no express warranties and in concluding that the implied warranties were not available to plaintiffs and in concluding that privity of contract of sale was required between Herbert Weldon Young and the defendants..... 14

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No. 15363

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

MILDRED MARIE YOUNG, individually and DANNY LEE YOUNG, DAVID RAY YOUNG and DANIEL RAY YOUNG, through their guardian *ad litem*, Mildred Marie Young,  
*Appellants,*

*vs.*

AEROIL PRODUCTS COMPANY INC., a corporation, STRUCTURAL MATERIAL COMPANY, a corporation and DERYL S. YUNDT,

*Appellees.*

---

Appeal From the United States District Court for the Southern District of California, Central Division.

---

## APPELLANTS' OPENING BRIEF.

---

### Statement of Jurisdiction.

It is alleged in the first amended complaint as follows:

(a) The defendant, Aeroil Products Company, Inc., is a citizen of the State of Delaware and was doing business in the State of California [Tr. Vol. I, p. 3, lines 1-5.]

(b) The defendant, Structural Material Company, is a citizen of the State of California. [Tr. Vol. I, p. 2, lines 21-25.]

(c) The defendant, Deryl S. Yundt is a citizen of the State of California. [Tr. Vol. I, p. 3, lines 7 and 8.]

(d) The plaintiffs are all citizens of the State of Texas. [Tr. Vol. I, p. 3, line 14.]

(e) The matter in controversy exceeds, exclusive of interest and costs, the sum of Three Thousand Dollars (\$3,000.00). [Tr. Vol. I p. 3, lines 16 and 17.]

(f) The occurrence being the subject of the action took place in Los Angeles County, State of California. [Tr. Vol. I, p. 3, lines 19 and 20.]

These facts were stipulated to being true and became a part of the facts ordered established by the pre-trial order. [Tr. Vol. I pp. 23 and 24.]

The trial court found these jurisdictional facts to be true as a part of the Findings of Fact. [Tr. Vol. I pp. 36 and 37.]

The United States District Court for the Southern District of California Central Division had jurisdiction under U. S. C. A. 28, Section 1332, which reads as follows:

“Sec. 1332. *Diversity of Citizenship: Amount in controversy.*

“(a) The district Courts shall have original jurisdiction of all civil actions where the matter in controversy exceeds the sum or value of \$3000.00 exclusive of interest and costs and is between:

“(1) Citizens of different states.”

The United States Court of Appeals for the Ninth Circuit has jurisdiction under the following statutes:

U. S. C. A. Title 28, Section 1291:

“*Final Decisions of district Courts.* The Courts of Appeals shall have jurisdiction of appeals from



all final decisions of the district courts of the United States . . . .”

U. S. C. A. Title 28, Section 1294:

*“Circuits in which decisions reviewable.* Appeals from reviewable decisions of the district and territorial courts shall be taken to the courts of appeal as follows:

“(1) From a district court of the United States to the court of appeals for the circuit embracing the district;”

U. S. C. A. Title 28, Section 2106:

*“Determination.* The Supreme Court or any other court of appellate jurisdiction may affirm, modify, vacate, set aside, reverse any judgment, decree, or order of a court lawfully brought before it for review, and may remand the cause and direct the entry of such appropriate judgment, decree, or order or require such further proceedings to be had as may be just under the circumstances.”

U. S. C. A. Title 2107:

*“Time for Appeal to Court of Appeals.* Except as otherwise provided in this section, no appeal shall bring any judgment, order or decree in an action, suit or proceeding of a civil nature before a court of appeals for review unless notice of appeal is filed, within thirty days after the entry of such judgment, order or decree.”

In this case the final judgment was entered on July 19, 1956. [Tr. Vol. I, p. 50, lines 16 and 17.] The Notice of Appeal was filed with the District Court on August 8, 1956. [Tr. Vol. I, p. 53, lines 13 and 14.] The Notice of Appeal was filed, therefore, within thirty days after the entry of the final judgment.

U. S. C. A. Title 28, Rules of Civil Procedure, Rule 73(a), second paragraph, first sentence:

“A party may appeal from a judgment by filing with the district court a Notice of Appeal.”

The Statement of Points on Appeal were filed with the District Court on August 8, 1956. [Tr. Vol. I, p. 58, lines 21 and 22.]

### Statement of the Case.

Aeroil Products Company, Inc., a corporation, assembled the portable elevator being the subject of this action in Los Angeles, California. Deryl S. Yundt, who was manager of Aeroil Products Company delivered the machine to H. L. Weigert who was the employer of Herbert Weldon Young. [Tr. Vol. I, pp. 24 and 25.] Structural Materials Company was the jobber of the machine in the sale. Sam Mulkey Company, Inc. the manufacturer was never in California and never did business in California. [Tr. Vol. I, p. 22.] The portable elevator was sold by defendants to H. L. Weigert on July 7, 1953. On July 7, 1953, H. L. Weigert was given a copy of Plaintiff's Exhibits 1 through 6, inclusive. The machine referred to in the Exhibits 1 through 6 inclusive is the same as that delivered to H. L. Weigert and the same as the machine referred to in the complaint as the machine that killed Herbert Weldon Young. [Tr. Vol. I, p. 26, lines 6-20.] That on March 3, 1953, Herbert Weldon Young moved the portable elevator away from a roof in the same way he and others had always moved it and the upper end descended and hit the pavement of a level street and then the undercarriage collapsed and Herbert Weldon Young's head was crushed between the tongue and axle of the machine. [Tr. Vol. II, p. 23, lines 22-25; p. 24, lines 1-25; p. 25, lines 1-22.]

The Aeroil Mulkey Portable All-Steel Elevator was negligently designed and constructed and the defect in the machine was inherent and hidden. [Tr. Vol. II, p. 173, lines 19-22; p. 196, lines 14-24.] The articulate member of the undercarriage toward the normally upper end of the conveyor was not constrained against motion toward the normally lower end of the conveyor except insofar as the weight of the conveyor resting upon it. When the normally upper end of the conveyor hit the ground, the articulate members of the undercarriage were not constrained against motion toward the normally lower end (but then the upper end) and because of the energy in the system of the machine caused by the tipping over of the machine the undercarriage collapsed as observed in the accident. [Tr. Vol. II, p. 173, line 24, to p. 197, line 12.] However, the tipping of the normally upper end of the conveyor so that it was down and the normally lower end was up did not injure Mr. Young. This would not have hurt him. It was the collapsing of the undercarriage that killed him. The plates or "riser" on the normally lower end of the machine had nothing to do with the collapse of the undercarriage. [Tr. Vol. II, p. 196, lines 14-24.] At the time of the accident the upper end of the elevator was 20 feet. [Tr. Vol. II, p. 71, lines 12-25; p. 23, lines 1-3.] The elevator was 24 feet with one 8 foot extension, over all length 32 feet. [Tr. Vol. II, p. 46, lines 14-15.] It was warranted that it could be raised to a height of 22 feet. [Pltf. Ex. 6.] Herbert Weldon Young weighed 142 pounds. [Tr. Vol. II, p. 165, lines 13-18.] Mr. Young was 5 feet, 10 inches tall. [Tr. Vol. II, p. 65, lines 17 and 18.] When the upper end of the conveyor is at a height of 20 feet and then the lower end of the machine is raised a vertical distance of 5 feet, 5 inches, it will just balance with

a man of 150 pounds weight holding onto it and exerting his full weight. If it goes beyond that point, then the 150 pound man cannot prevent the further tipping over, he has no more weight to exert; he is used up. If a man was not able, or didn't exert his full weight before this point was reached, then the machine continues to tip over. [Tr. Vol. II, p. 189, lines 21-25; p. 190, lines 1-5.]

The defendants made certain express warranties in advertising material. In Plaintiffs' Exhibit 6, among other things, it was stated

“Aeroil Portable Equipment for the Modern Roofer, Aeroil Mulkey Commercial All-Steel Portable Elevator, Look at these Mulkey Features, Balanced and Portable, One man can handle and operate, Eliminates Back-Breaking Labor Fatigue, 24 ft. elevator will accommodate 1—8 ft. extension, height 22 ft., undercarriage moves forward for proper balance.”

Then, in Plaintiffs Exhibit 1 it is stated

“The Mulkey Commercial All-Steel Portable Elevator It's Balanced! Only Mulkey offers you all these features, they perform with amazing speed, Nationally advertised. Nationally accepted, Fully Guaranteed! It is truly the contractor's greatest friend and labor saver. 3 special features of the Mulkey Elevator, Easily Maneuvered, New improved winch assembly easily raises elevator with extensions, Balanced undercarriage. Adjustable to accommodate extensions, balancing permits 1 man to handle and operate! (points to picture with elevator in raised position).”

Throughout the Exhibits 1 through 6 are pictures of the machine in operation in a raised position with one man

handling and operating the machine. In plaintiffs Exhibit 1 there is a picture which states: "This Mulkey is rapidly raising heavy loads of gravel to a 22 foot high rooftop" and over the picture it states: "Mulkey has proved itself." The height of the rooftop that was being loaded by Mr. Young was between 17 to 18 feet. [Tr. Vol. II, p. 71, lines 12-25.] The defendants made these warranties without any tests or investigation to determine the truth of them at all. [Tr. Vol. II, p. 83, line 22, to p. 84, line 17.]

The deceased, Herbert Weldon Young, and the other workmen who used the machine were given Plaintiffs' Exhibits 1 through 6 to rely on as to the handling and operation of the machine. [Tr. Vol II, p. 53, lines 18-21; p. 54, lines 2-6; p. 130, lines 4-25; p. 131, lines 1-2; p. 136, lines 5-18, p. 140, lines 4-9.] Herbert Weldon Young was justified in relying on the advertising statements made by the defendants.

### Specification of Error.

#### I.

The District Court erred in giving judgment for defendants.

#### II.

The District Court erred in concluding, as a matter of law, the notice of breach of the express warranty is required as a condition precedent to plaintiff's recovery. The District Court erred in not applying the tort rule in this respect.

#### III.

The District Court erred in concluding that privity of contract of sale of the conveyor between Herbert Weldon Young and the defendants was required for plaintiff's recovery.



IV.

The District Court erred in concluding from the evidence that the plaintiffs as a matter of law did not prove a cause of action against defendants.

V.

The District Court erred as a matter of law that plaintiffs were required to prove a cause of action for either warranty, or negligence, or deceit for the reason that the plaintiff's cause of action is one cause of action under the law which the plaintiffs proved.

VI.

The District Court erred in concluding as a matter of law there were no express warranties.

VII.

The District Court erred as a matter of law in concluding that implied warranties are not available to plaintiffs as a grounds for recovery.

VIII.

The District Court erred in not finding that Herbert Weldon Young relied on the express warranties made by the defendants concerning the conveyor. The court made no finding on this matter. It was made an issue of the case as a part of the pre-trial order. [Tr. Vol. I, p. 30, lines 3-7.]

IX.

The District Court erred in not awarding damages to the plaintiffs in the sum prayed for in the complaint.

X.

The District Court erred in finding "that the booklet designated 'Aeroil Products Company, Inc., Catalogue of Roofer's Equipment' plaintiffs Exhibit 6, did not enter into or become part of the contract of sale of the con-

veyor to H. L. Weigert” for the reason that this is not supported by the evidence and is an erroneous conclusion of law because it is advertising material and as a matter of law is a part of the contract of sale.

XI.

The District Court erred in finding “that H. L. Weigert did not rely on any express warranty contained in said booklet in the purchase of said conveyor, nor were any of these express warranties any inducement to the sale of said conveyor” for the reason that this is not supported by the evidence.

XII.

The District Court erred in finding “That the brochure designated ‘the Mulkey Commercial All-Steel Portable Elevator, Its Balanced’ Plaintiffs Exhibit 1, did not enter into or become part of the contract of sale of the conveyor to H. L. Weigert” for the reason that this is not supported by the evidence and is an erroneous conclusion of law.

XIII.

The District Court erred in finding “That H. L. Weigert did not rely on any express warranty contained in said brochure in the purchase of said conveyor, nor were any warranties contained in said brochure any inducement to the sale of said conveyor” for the reason that this is not supported by the evidence.

XIV.

The District Court erred in finding “That said brochure or booklet or either of them did not constitute any warranties to said Herbert Weldon Young” for the reason that this is not supported by the evidence and is an erroneous conclusion of law from the evidence.

XV.

The District Court erred in finding "That no express warranties were made by Aeroil Products in the sale of the said conveyor" for the reason that this is not supported by the evidence and is an erroneous conclusion of law from the evidence.

XVI.

The District Court erred in finding "That at the time the conveyor was delivered and accepted by H. L. Weigert said conveyor was free from any defects and that said conveyor at the time of the sale and delivery of the conveyor to H. L. Weigert was of merchantable quality" for the reason that this is not supported by the evidence and is an erroneous conclusion of law from the evidence.

XVII.

The District Court erred in finding that "None of the implied warranties contained in the sale of the conveyor of H. L. Weigert ran to Herbert Weldon Young", for the reason that this is an erroneous conclusion of law.

XVIII.

The District Court erred in finding "that said conveyor was not negligently designed or constructed" for the reason that this is not supported by the evidence.

XIX.

The District Court erred in finding

"That there were no latent defects in said conveyor, and that said conveyor was not inherently defective in design or construction, and that said conveyor was not dangerous to life and limb of a possible user"

for the reason that this is not supported by the evidence.



XX.

The District Court erred in finding

“That no inspection of said conveyor required to be made by Deryl S. Yundt or Aeroil Products, Inc. as assembler and distributor of said conveyor would disclose any defect in the conveyor.

“That Deryl S. Yundt or Aeroil Products or Structural Materials or any of them did not negligently test or inspect said conveyor after assembling it and before selling it to H. L. Weigert, and no negligence on the part of the aforesaid defendants or any of them proximately caused or contributed to the death of Herbert Weldon Young.”

XXI.

The District Court erred in finding “That Aeroil Products, as assembler and distributor of said conveyor, had no duty to test said conveyor for defects in design or construction” for the reason that under the evidence of this case this is an erroneous conclusion of law.

XXII.

The District Court erred in finding “That no negligent misrepresentations were made by Aeroil Products in regard to said conveyor” for the reason that this is not supported by the evidence.

XXIII.

The District Court erred in finding “That no representations or misrepresentations were made by Aeroil Products with intent to induce H. L. Weigert to purchase said conveyor” for the reason that this is not supported by the evidence.

XXIV.

The District Court erred in finding “That H. L. Weigert at no time relied on any representations or misrep-

representations made by Deryl S. Yundt, or Structural Materials, or Aeroil Products, or any of them, in the purchase of said conveyor” for the reason that this is not supported by the evidence.

XXV.

The District Court erred in finding “That any representations made by Aeroil Products, Inc. in regard to said conveyor were true” for the reason that this is not supported by the evidence.

XXVI.

The District Court erred in finding

“That the presence of said undercarriage, or riser, and lowering of the hitch created a hazard of overbalancing said conveyor when lifting the hitch end of said conveyor high enough to cause said conveyor to be moved”

for the reason that this is not supported by the evidence.

XXVII.

The District Court erred in finding

“That prior to the accident, Herbert Weldon Young was aware of the changes, repairs, and toppling of the conveyor and voluntarily and knowingly assumed any and all risk incident to the operation of said conveyor after having been changed and repaired, and that Herbert Weldon Young was negligent in his use of said conveyor on March 3, 1954, and said negligence was a proximate cause of his death, and that at the time of the accident, Herbert Weldon Young did not use, operate and move said conveyor in a manner instructed for the use of said conveyor and that Herbert Weldon Young was negligent”

for there is no evidence to support these findings.

### Summary.

The defendants made certain warranties by means of advertisements that were distributed to the general public. The representations were obviously intended to influence and be relied on by any person interested. The California courts have held in *Burr v. Sherwin Williams Co.*, 42 Cal. 2d 682, 268 P. 2d 1041, that representations made by a seller in advertising material relied on by the user create strict liability on the seller for misrepresentations without privity of contract. The reason for this is that the seller, by sending the statements out as advertisements to many people, went beyond the personal contract with the buyer and induced persons other than the buyer to rely on seller's false statements which in the present case caused the death of Herbert Weldon Young who was the father to some of the plaintiffs and the husband of Mildred Marie Young. [Tr. of Record on Appeal, Vol. II, p. 53, lines 16-21; p. 54, lines 2-6; p. 18, lines 18-25; p. 19, lines 1-6; p. 27, lines 1-8; p. 130, lines 4-25; p. 131, lines 1-5; p. 136, lines 5-18; p. 140, lines 4-19; p. 173, lines 19-22; p. 196, lines 6-24; p. 23, lines 22-25; p. 24, lines 1-25; p. 25, lines 1-22; p. 75, lines 10-25; p. 76, lines 1-17; Vol. I p. 26, lines 6-20; p. 25, lines 3-7; p. 23, lines 13-20.]

## ARGUMENT.

### I.

The Court Erred in Giving Judgment for Defendants by Concluding From the Evidence That the Plaintiffs as a Matter of Law Did Not Prove a Cause of Action Against Defendants and That as a Matter of Law the Plaintiffs Were Required to Prove a Cause of Action for Either Warranty, or Negligence, or Deceit Because It Is One Cause of Action Being a Hybrid of Contract and Tort, and in Concluding as a Matter of Law There Were No Express Warranties and in Concluding That the Implied Warranties Were Not Available to Plaintiffs and in Concluding That Privity of Contract of Sale Was Required Between Herbert Weldon Young and the Defendants.

The facts in this case present somewhat of an unusual cause of action. It is a combination of contract law and tort law and has been referred to by Prosser "Law of Torts, 2nd Ed. Pg. 493" as "The seller's warranty is a curious hybrid of tort and contract, unique in the law."

The general rule is that between a buyer and seller privity of contract is required on a breach of warranty. This contemplates the warranty was made by the seller only to the buyer. However, where the seller publishes his warranty to all who may see it by advertisements, the warranty is made to the user of the product who relies on it and the traditional idea of privity of contract does not apply. The warranty is no longer tied to the sale but it is spread to anyone who will receive it and rely on it. This is also supported by *Gagne v. Bertran*, 43 Cal. 2d 481, 275 P. 2d 15; and *Free v. Sluss*, 87 Cal. App. 2d Supp. 933, 197 P. 2d 854. When a seller spreads

his warranty to all who will see it and rely on it, he assumes a strict liability for innocent misrepresentations of fact that he purports to know and that the recipient relies upon to his damage. The case of *Sheward v. Virtue*, 20 Cal. 2d 410, 126 P. 2d 345, is another California case that recognizes this strict liability.

“The Courts of this state (California) are committed to the doctrine that the duty of care exists in absence of privity of contract not only where the article manufactured is inherently dangerous, but also where it is reasonably certain, if negligently manufactured or constructed, to place life and limb in peril.”

A portable elevator is a machine which if negligently constructed is reasonably certain to place life and limb in peril. [Tr. Vol. II, p. 59, line 6, to p. 61, line 5.] In the present case, Aeroil Products Company assembled and sold a portable elevator [Tr. Vol. I, p. 25, lines 3-7; p. 26, lines 16-20] which was negligently designed and constructed [Tr. Vol. II, p. 173, lines 19-22; p. 196, lines 14-24] so that the head of Herbert Weldon Young was crushed. [Pltf. Exs. 7-13.] Aeroil warranted through advertisements [Pltf. Exs. 1-6] that the elevator could be handled by one man and that it was balanced and portable. One man was handling the machine and it killed him. [Tr. Vol. II, p. 59, lines 7-19.] The articulate member of the undercarriage toward the normally upper end of the conveyor was not constrained against motion toward the normally lower end of the conveyor except insofar as the weight of the conveyor resting upon it. When the normally upper end of the conveyor hit the ground, the articulate members of the undercarriage were not constrained against motion toward



the normally lower end (but then the upper end) and because of the energy in the system of the machine caused by the tipping over of the machine the undercarriage collapsed as observed in the accident. [Tr. Vol. II, p. 173, line 24, to p. 197, line 12.] The tipping of the normally upper end of the conveyor so that it was down and the normally lower end was up did not injure Mr. Young. This would not have hurt him. It was the collapsing of the undercarriage that killed him. The plates or "riser" on the normally lower end of the machine had nothing to do with the collapse of the undercarriage. [Tr. Vol. II, p. 196, lines 14-24.] The warranty of the assembler and seller of the machine is unqualified that "It's Balanced!", "Balanced and Portable", "One man can handle and operate", "Easily Maneuvered", "Balanced Undercarriage", "Balancing permits one man to handle and operate". However, when the upper end is at a height of 20 feet and then the lower end of the machine is raised a vertical distance of 5 feet 5 inches, it will just balance with a man of 150 pounds weight holding on to it and exerting his full weight. If it goes beyond that point, then the 150 pound man cannot prevent the further tipping over, he has no more weight to exert; he is used up. If a man was not able, or didn't exert his full weight before this point was reached, then the machine continues to tip over. [Tr. Vol. II, p. 189, lines 21-25; p. 190, lines 1-5.] Mr. Young was 5 feet 10 inches tall. [Tr. Vol. II, p. 65, lines 17-18.] Therefore, to hold it, to keep it from tipping over, to prevent it from getting above the head of the handler, there is more weight needed than one man has. The representation and warranty was false. Aeroil Products Company made these warranties and representations without any tests or investigation to de-

termine the truth of them at all. [Tr. Vol. II, p. 83, line 22, to p. 84, line 17.] When the conveyor tipped over, the undercarriage was not balanced, it collapsed. The machine was, therefore, not balanced so as to hold together when the normally upper end came in contact with the ground. And, of course, in this position it was not portable. [Tr. Vol. II, p. 12, lines 9-14.]

Structural Material Company was involved in the sale and in the warranties through Deryl S. Yundt who was manager of Aeroil. [Tr. Vol. I, p. 25, lines 7-22.]

Aeroil Products Company assembled the portable elevator [Tr. Vol. I, p. 25, lines 3 and 4] and made numerous express warranties or representations in advertising material [Tr. Exs. 1-6] that were sent out to the public [Tr. Vol. II, p. 75, line 10, to p. 76, line 9] and delivered along with the machine. [Tr. Vol. II, p. 80, lines 3-7.] Aeroil gave its name to the portable elevator by advertising the machine as the "Aeroil Mulkey Commercial All-Steel Portable Elevator". [Pltf. Ex. 6.] Some of the express representations in the advertising material states "Balanced undercarriage . . . balancing permits 1 man to handle and operate!" and points to a picture showing the elevator in a raised position. [Pltf. Ex. 1.] Also, the advertisement states "Undercarriage moves forward for proper balance." This advertising material was shown to Herbert Weldon Young, deceased. [Tr. Vol. II, p. 15, lines 17-25; p. 16, lines 1-13; p. 18, lines 12-25; p. 19, lines 1-6.] On the day of the accident, he was in the process of moving the portable elevator away from the roof of a house and the undercarriage collapsed and crushed his head. He was moving the machine no differently than it was always moved. [Tr. Vol. II, p. 25, lines 1-14.]

The general rule is that privity of contract is required in an action for the breach of an express or implied warranty. However, there are two exceptions to this rule recognized by California law, to-wit:

- (a) No requirement of privity of contract in cases involving foodstuffs.
- (b) No requirement of privity of contract in cases where the person using the product relied on representations made by the seller in advertising material. Recovery was allowed on the theory of express warranty.

The above principles and supporting cases are found in *Burr v. Sherwin Williams Co.*, 42 Cal. 2d 682, 268 P. 2d 1041. The opinion was written by Chief Justice Gibson of the California Supreme Court.

In the California Supreme Court opinion written by Justice Traynor, found in *Gagne v. Bertran*, 43 Cal. 2d 481, 275 P. 2d 15, it is stated:

“Strict liability has also been imposed for innocent misrepresentations of facts that the maker purported to know, that the recipient relied on to his damage and that the maker positively affirmed under circumstances that justify the conclusion that he assumed responsibility for their accuracy.”

It is further pointed out in the same opinion that the seller is “presumed” to know the truth (*Edwards v. Sergi*, 137 Cal. App. 369, 30 P. 2d 541) and that the representation need not be made with knowledge of actual falsity, but need only be an “assertion, as a fact, of that which is not true, by one who has no reasonable ground for believing it to be true.” (Civ. Code, Sec. 1710.) The intent required by this section is nothing more than an



intent to "induce action" and an "intent to deceive" is not required. The Court further pointed out that the measure of damages in such a case is the actual loss suffered because of the misrepresentation. Finally, the Court concluded that if plaintiff alleged and proved facts that justify the application of the above principles the labeling of the cause of action is immaterial.

The seller cannot say that the deceased was negligent in relying on his warranty. If seller could do this he would be hiding behind his own wrong. The test is whether or not considering the experience, education and intelligence of the deceased, whether or not it could be concluded that he was justified in relying on the warranty. Seller warranted that one man could handle the machine. Herbert Weldon Young was justified in relying on this warranty. The design and construction defect was hidden and not known to him. [Tr. Vol. II, p. 51, lines 1-12.] He was justified in relying on seller's statement that one man could handle the elevator. He was justified in believing, therefore, that if he handled the machine it was safe for him to do so and under the circumstances any workman would have so believed. [Tr. Vol. II, p. 60, line 23, to p. 61, line 4.] (Prosser Law of Torts, 2nd Ed., p. 493.)

The California Courts have applied the tort rule in this type of case to survival of actions, the statute of limitations, the liberal tort rule as to damages, and have allowed recovery for wrongful death. (*Gosling v. Nichols*, 59 Cal. App. 2d 442, 139 P. 2d 86; *Rubino v. Utah Canning Co.*, 123 Cal. App. 2d 18, 266 P. 2d 163; *Greco v. S. S. Kresge Co.*, 277 N. Y. 26, 12 N. E. 2d 557, 115 A. L. R. 1020.)

Notice is not required to be given as a condition precedent to the commencement of a tort action. In this case the user of the seller's product was killed. He could not give notice. However, in this case actual notice was given by the deceased's employer immediately after the accident occurred. [Tr. Vol. II, p. 82, line 4, to p. 83, line 2; p. 135, lines 4-24.] There is no requirement in law under the rules of tort actions to require the wife or minor children of the deceased to give notice. (*Rubino v. Utah Canning Co.*, 123 Cal. App. 2d 18, 266 P. 2d 163.) The gravamen of a cause of action for breach of an express warranty where the user of the product relied on representations made by the seller in advertising material which results in death or injury "sounds in tort." The cause of action is not *ex contractu*. (*Gosling v. Nichols*, 55 Cal. App. 2d 442, 139 P. 2d 86.)

The trial court made no finding of fact on reliance by Herbert Weldon Young on the express warranties contained in the advertising material. The Court seemed to only look at it as to whether the employer of the deceased relied on the expressed warranties. The employer testified he did rely on the express warranties. [Tr. Vol. II, p. 151, lines 2-9; p. 136, lines 5-18.] However, what the employer relied on is not the question. The reliance that is probative is the reliance of the deceased employee. This is proved by his having read the warranties and he was using the machine as warranted. ("One man can handle and operate.") [Pltf. Ex. 6; Tr. Vol. II, p. 53, lines 16-21; p. 19, lines 3-6; p. 54, lines 2-6.] It is also proved by the reliance of the other workman who moved it, to-wit: Mr. Thomas. [Tr. Vol. II, p. 54, lines 2-6.] The defect was hidden. None of the workmen or the employer knew of it. [Tr. Vol. II, p. 51, lines

1-12; p. 40, lines 11-17.] The deceased cannot be produced to testify. Therefore, we submit that reliance of the deceased was proved. He was justified in relying on the express warranties. There was no negligence on the part of the deceased in relying on the express warranties. To permit the defendants to be held blameless because the deceased relied on their warranty would be permitting the defendants to hide behind their own wrong.

The case of *MacPherson v. Buick Motor Co.*, 217 N. Y. 382, 111 N. E. 1050, did not go beyond the ultimate purchaser himself. However, the later cases have extended strict liability to the purchaser's employees. (*Kalash v. Los Angeles Ladder Co.*, 1 Cal. 2d 229, 34 P. 2d 481.)

It is now generally recognized that a manufacturer and a dealer has a responsibility to the ultimate consumer, based upon nothing more than the sufficient fact that he has so dealt with the goods that they are likely to come into the hands of another, and to do harm if they are defective. (Prosser on Torts, 2nd Ed., p. 498, Note 9.)

“The battle over liability for negligence has been fought and won by plaintiff, both in England and in the United States, and the scene of combat is now being shifted to the question of strict liability, on the basis of some form of implied warranty where there is no contract.”

This brings me to a discussion of the applicability of implied warranty to this case. The California cases, *Temeroli v. Austin Trailer Equipment Co.*, 102 Cal. App. 2d 464, 227 P. 2d 923 (Uniform Sales Act, Sec. 1735, Sub. 1, Civ. Code of Calif.), held that under the Uniform

Sales Act, the implied warranty of fitness for the purpose for which it was purchased extends to latent defects which the seller had no knowledge of. This case further points out that even though the seller could not have discovered the latent defect by inspection that any hardship on the seller is alleviated by the fact that the seller may recover from the manufacturer any damages recovered from the seller by the ultimate user. In the case before the Court, the user was the employee of the buyer and was a class of person who the seller knew would be using the machine, therefore, the implied warranty of fitness runs to the employee as much as it does to the buyer because the employee in this case was using the machine for his employer. The seller knew the buyer's employee would use the machine and it was the very purpose of the machine's existence to be used by the buyer's laborers. [Ex. 1.] Therefore, the plaintiffs are entitled to rely on an implied warranty that there were no latent or hidden defects in the machine due to negligent design and construction that would cause damage to the employee of the buyer who was one of the class of persons seller intended the machine to be used by. We have in this case, both express warranties and implied warranty. Either will support plaintiffs right to recover.

I wish to further point out that the tort elements of the warranty include both rules of negligence and rules of deceit. The case of *Gange v. Bertran* (*supra*) points this out. "The positive assertion in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true" is a negligent misrepresentation. (Cal. Civ. Code, Sec. 1572, Sub. 2.) As I have heretofore pointed out, knowledge by the seller of actual falsity of the statement is

not necessary. The reason for this is that in modern trade a seller owes a duty to the users of his product to make warranties about his product only after the seller knows they are true. In the present case, Aeroil made the warranties without any investigation to see if they were true. [Tr. Vol. II, p. 83, line 22, to p. 84, line 17.] By making these warranties the deceased was caused to rely on them and he was killed. In our society we of necessity must rely on the warranties of the seller. The products placed on the American market are highly specialized and we as consumers can expect that the seller will make warranties only after he knows they are true. Otherwise, each and every one of us would be in mortal peril every minute of the day. The California Courts have recognized the fact that a type of action like the one at issue is important to our society for the reason that each of us are confronted every minute of our lives by machines and gadgets that if they are negligently designed and constructed will place us in peril of life and limb. (*Escola v. Coca-Cola Bottling Co. of Fresno*, 24 Cal. 2d 453, 150 P. 2d 436.) And particularly when a seller makes an express warranty about his machine he assumes strict liability for the truth of the warranty and owes a duty to everyone who relies upon it that the person relying upon it will not thereby be placed in danger of life and limb. (*Lane v. Swanson & Sons*, 130 Cal. App. 2d 210, 278 P. 2d 723.)

What is an express warranty? This is discussed in the "boned chicken" case, to-wit: *Lane v. C. A. Swanson & Sons*, 130 Cal. App. 2d 210, 278 P. 2d 723. There the Court says:

"Any affirmation of fact or any promise by the seller relating to the goods is an express warranty



if the natural tendency of such affirmation or promise is to induce the buyer to purchase the goods.” (Civ. Code, Section 1732; *Scott v. Johnson*, 36 Cal. 2d 864, 869-870, 229 P. 2d 348, 28 A. L. R. 2d 580.)

The Court further points out, in the case of *Lane v. C. A. Swanson & Sons* (*supra*), that the tendency of the modern cases is to construe liberally in favor of the user of the product the language used by the seller in making affirmations respecting his goods in advertising material and to enlarge the responsibility of the seller to construe every affirmation by him to be a warranty when such construction is at all reasonable. The Court further pointed out that representations in advertisements may be considered as a part of the contract of sale. In this case the retailer was held responsible for damages resulting from a piece of bone in chicken that was advertised as “boned”.

The defendant, Aeroil Products Company, owed the duty to the person who relied on the express affirmation of fact made about the machine to determine the truth of the statements. The defendant, Aeroil Products Company, gave its reputation to the statements. A seller-assembler of the machine is under the duty to investigate to determine the truth of the express warranties. The one who suffers injury from a defective product is unprepared to meet its consequences. The cost of the injury and the loss of time, life or health may be an overwhelming misfortune, as in this case, to the family of the workman and a needless one for the risk of in-

jury from reliance on false advertising affirmations of fact can be prevented by the seller-assembler making the advertising statement, only if he is sure of their truth after tests and investigation. It is to the public interest to discourage the marketing of products having defects that are a menace to the public. If such products nevertheless find their way into the market and are sold by advertising statements that are untrue resulting from failure to test and investigate, it is to the public interest to place the responsibility for whatever injury they may cause upon the person making the false advertising statement. [Pltf. Ex. 6.] In this case, this machine was not safe for one man to handle. By stating that one man can handle the machine it is an affirmation of fact that one man can safely do so. Also, it is stated the machine is balanced. When a machine is said to be balanced, one would conclude that it is safe. The machine, when raised as in this case, was not balanced when the normally upper end hit the ground because then the undercarriage would collapse. It makes no difference how intermittently such injuries may occur or how haphazardly they may strike, the risk of their occurrence is a constant risk and a general one. (*Escola v. Coca-Cola Bottling Co. of Fresno*, 24 Cal. 453, 150 P. 2d 436.) (Justice Traynor concurring opinion.) Aeroil Products Company in their catalog No. 418 Y state:

“Aeroil Portable Equipment for the Modern Roofer, Aeroil Mulkey Commercial All-Steel Portable Elevator, Look at these Mulkey Features, Balanced and Portable, One Man can Handle and Oper-

ate, Eliminates Back-Breaking Labor Fatigue, 24 ft. elevator will accommodate 1—8 ft. extension, height 22 ft. undercarriage moves forward for proper balance.”

In this case the upper end of the elevator was at a height of 20 feet. [Tr. Vol. II, p. 71, lines 12-25; p. 23, lines 1-3.] When it tipped over on a level paved street and the upper end hit the ground, the undercarriage collapsed because of a defect in construction and design as testified to by Dr. Wood. The defendants put on no evidence. They presented no expert to contradict Dr. Wood. This machine was inherently dangerous and created a constant risk to any person using it. The defendant, Aeroil, made no tests to determine the truth of the statements made by them. This is a negligent misrepresentation which public policy requires the defendants be held responsible for.

California Code of Civil Procedure provides in Section 1963 that there is a disputable presumption that a person takes ordinary care of his own concern. Mr. Young, therefore, is presumed to have been careful and not negligent. It is up to the defendant to rebut this presumption. As pointed out heretofore the witnesses said Mr. Young did nothing in the handling of the machine other than was customarily done. The defendants did not rebut the presumption of due care that Mr. Young is clothed in.



II.

**The Court Erred in Not Awarding Damages to the Plaintiffs in the Sum Prayed for in the Complaint.**

Herbert Weldon Young was earning net take home pay of \$306.70 per month. [Tr. Vol. I, p. 27, lines 3-6.] Mr. Young was 29 years of age at his death. His life expectancy was 38 years, 223 days. The ages of all the plaintiffs are younger than the deceased. Their life expectancy would be greater. [Tr. Vol. II, p. 247, lines 16-20.] The defendants stipulated that the deceased was a kind and loving husband and father to his wife and children. [Tr. Vol. II, p. 245, lines 23-25.] The funeral expense of the deceased was \$1200. [Tr. Vol. I, p. 27, lines 7-8.] One of the plaintiffs, Danny Lee Young, is an invalid requiring constant medical attention. [Tr. Vol. II, p. 251, lines 2-12; p. 252, lines 13-16; p. 253, lines 4-7.] The expected earnings of deceased net if his life had not been cut short is \$140,000. The plaintiffs are entitled to damages in this type of case in the loss arising from a deprivation of benefits which, from all the circumstances of the case, it could be reasonably expected each of the plaintiffs would have received from the deceased had his life not been taken. This includes the pecuniary value of loss of society, comfort, protection nurture, and education and support and the reasonable expectation of pecuniary advantage to each plaintiff from the continuance of the life of the deceased. Another element is the damage suffered by each plaintiff by the death, is the future financial assistance each plaintiff might reasonably expect from a continuance of the life of the deceased.

In this case one of the children is an invalid. The fact that Danny Lee Young could expect financial support during the child's entire life is an element of fact that is to be compensated for. This child can never be expected to earn his own living and needs constant medical attention which his father was furnishing and which he could have expected during his life, limited only by the father's life expectancy. (*Blackwell v. American Film Co.*, 189 Cal. 689, 209 Pac. 999; *Ure v. Maggio Bros. Co.*, 24 Cal. App. 2d 490, 75 P. 2d 534; *Simoneau v. Pacific Electric Ry. Co.*, 116 Cal. 265, 136 Pac. 544.)

### III.

#### **The Findings of Fact by the Trial Court Are Not Supported by the Evidence as Specified in the Specification of Error. [Tr. Vol. I, pp. 54-58.]**

H. L. Weigert did rely on the express warranties contained in Plaintiff's Exhibits 1 through 6 in the purchase of the conveyor and these express warranties were an inducement to the sale of the conveyor. [Tr. Vol. II, p. 151, lines 2-9; p. 130, lines 4-25; p. 131, lines 1-2; p. 136, lines 5-18; p. 140, lines 4-9; p. 142, lines 16-25; p. 143, lines 1-2.] As a matter of law the California Courts have held that representations in advertisements are to be considered as a part of the contract of sale. (*Lane v. C. A. Swanson & Sons*, 130 Cal. App. 2d 210, 278 P. 2d 723.)

The brochures or booklets and each of them [Pltf. Exs. 1-6, incl.] do constitute warranties to Herbert Weldon Young. He was the employee of the purchaser. The

machine was intended to be used by the employee. The case of *Kalash v. Los Angeles Ladder Co.*, 1 Cal. 2d 229, 34 P. 2d 481, establishes the duty of the seller to the purchaser's employee.

Aeroil Products Company, Inc., did make express warranties in the sale of the conveyor. Plaintiff's Exhibits 1 through 6 were delivered to H. L. Weigert, the deceased's employer, at the time of the delivery and sale of the machine. [Tr. Vol. I, p. 38, lines 16-25; p. 39, lines 1-3; p. 26, lines 6-20.] Mr. Yundt who was manager of Aeroil Products Company, Inc., only made statements to Weigert about the machine from the advertising material. [Pltf. Exs. 1-6; Tr. Vol. II, p. 80, lines 3-7.]

At the time the conveyor was delivered and accepted by H. L. Weigert, the conveyor was not free from any defects and the conveyor at the time of the sale and delivery of the conveyor to H. L. Weigert was not of merchantable quality. All one needs do is read Dr. Wood's uncontradicted testimony concerning the conveyor and then ask yourself if you would risk your life by using the machine. I am sure you would stay away from the machine, because it is a death trap. The defect is in design and construction. [Tr. Vol. II, p. 171, line 21, to p. 173, line 21; p. 196, lines 6-25; p. 197, lines 1-12.] The conveyor was negligently designed and constructed. There is no evidence to the contrary. The defect is latent. It cannot be seen by the eye and the workmen using the machine did not know of it. [Tr. Vol. II, p. 51, lines 1-12; p. 140, lines 11-17.]

Aeroil Products Company, Inc., as assembler and distributor of the conveyor had a duty to test the conveyor for defects in design or construction. (*Escola v. Coca-Cola Bottling Co. of Fresno*, 24 Cal. 2d 453, 150 P. 2d 436.) Aeroil Products made negligent misrepresentations in regard to the conveyor. Aeroil Products Company handed out all of the advertising in California. The Sam Mulkey Company was never in California at any time. [Tr. Vol. I, p. 22.] All of the statements in Plaintiff's Exhibits 1 through 6 were sent out to the public by Aeroil Products and were intended to induce the purchase of the conveyor. H. L. Weigert testified that he relied on the representations. [Tr. Vol. II, p. 136, lines 5-18; p. 140, lines 4-9.]

The representations in the advertising material made by Aeroil Products in regard to the conveyor were not true. [Tr. Vol. II, p. 173, lines 19-21; p. 196, lines 6-24.]

There is no evidence to support the finding

“that the presence of said undercarriage or riser and lowering of the hitch created a hazard of overbalancing said conveyor when lifting the hitch end of said conveyor high enough to cause said conveyor to be moved.”

The changing of the normally lower end to be the upper end of the conveyor did not kill Mr. Young. It was the collapse of the undercarriage due to the fact of its defect in design and construction. The undercarriage was not balanced when the normally upper end see-sawed

over to become the lower end. The collapse of the undercarriage had nothing to do with the “riser” or the lowering of the hitch. [Tr. Vol. II, p. 196, lines 6-24.]

Herbert Weldon Young was in no way negligent. He moved the conveyor no differently than before or as others had moved it. The defect was there and an ever constant danger. He had no warning and no knowledge of it. The collapse of the undercarriage occurred with great speed. He was killed within three or four seconds. [Tr. Vol. II, p. 24, lines 16-18.]

Respectfully submitted,

ARLO E. RICKETT, JR.,

*Attorney for Appellants.*



No. 15363.

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

MILDRED MARIE YOUNG, individually and DANNY LEE  
YOUNG, DAVID RAY YOUNG and DANIEL RAY YOUNG,  
through their guardian *ad litem*, Mildred Marie Young,  
*Appellants,*

*vs.*

AEROIL PRODUCTS COMPANY INC., a corporation, STRUC-  
TURAL MATERIAL COMPANY, a corporation, and DERYL  
S. YUNDT,

*Appellees.*

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On Appeal From the United States District Court for the  
Southern District of California, Central Division.

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## APPELLEES' BRIEF.

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No. 15363.

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

MILDRED MARIE YOUNG, individually and DANNY LEE YOUNG, DAVID RAY YOUNG and DANIEL RAY YOUNG, through their guardian *ad litem*, Mildred Marie Young,  
*Appellants,*

*vs.*

AEROIL PRODUCTS COMPANY INC., a corporation, STRUCTURAL MATERIAL COMPANY, a corporation, and DERYL S. YUNDT,

*Appellees.*

---

On Appeal From the United States District Court for the Southern District of California, Central Division.

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## APPELLEES' BRIEF.

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Appellants have filed their alleged opening brief in the above entitled matter. Appellees have no quarrel with the statement of jurisdiction except with reference to the last paragraph thereof. On page 4 of their opening brief appellants allege that a statement of points on appeal was filed with the District Court on August 8, 1956. Appellees admit that a certain document so designated was filed on said date but allege and earnestly contend that said document does not comply with the rules of procedure of this court and is not sufficiently definite

or specific to confer jurisdiction on this court. Rule 18, 2(d), 46, 52(a) of the Rules of the U. S. Court of Appeals for the Ninth Circuit. This point will be more specifically argued and referred to in Point One of this brief.

Appellees contend that the alleged statement of the case set out in Appellants' opening brief is inaccurate and woefully incomplete. While this appeal is based almost entirely on the alleged insufficiency of the evidence the appellants have not set out all or in fact more than a small portion of the evidence. While appellees feel that the duty to do this rests with appellants they have nevertheless prepared a general condensation of the evidence, with appropriate transcript references, which is included in this brief under the heading of Statement of the Evidence. By so doing, appellees wish to assist this court in determining what the evidence actually was at the trial of the above action. However, appellees are not waiving any rights that they may have to object to the accuracy or sufficiency of the Statement of the case as set out in Appellants' opening brief.

### **Appellees' Counter-Statement of Facts.**

Aeroil Products Company acted as a distributor of the Mulkey Conveyor in California. They did some minor assembling of the conveyor prior to delivery. However, they did not manufacture the conveyor or any of its component parts. Further, Aeroil had nothing to do with the design of the conveyor or of any of its parts. [Rep. Tr. p. 83, lines 3-23.] Harmon L. Weigart, a roofer of many years' experience, became acquainted with the Mulkey conveyor and other similar conveyors while he was working for the Bennett Roofing Company, long before



he went into business for himself in 1952. When he went into business he was thoroughly conversant with Mulkey Conveyors, how they were operated, how they were built, what they would do, and how they were used. [Rep. Tr. p. 141, line 7, to p. 142, line 23.] He had known the defendant Yundt, who at that time was manager of the Aeroil Products Company, for many years. When he went to see Yundt he had already decided that he wanted and wished to get a Mulkey Conveyor. [Rep. Tr. p. 142, line 23, to p. 143, line 24.] When he bought the conveyor he was given a Mulkey brochure. He had seen them previously while working for Bennett. [Rep. Tr. p. 149, line 12, to p. 151, line 14.] He carefully instructed his employees, including Herbert Young, the decedent herein, as to the use of the conveyor. That it was to be set at an angle to the house, that the wheels had to be level and that the wheels were not to go over rocks or bricks, or anything of that nature. Young operated the conveyor more than any of his other employees. [Rep. Tr. p. 143, line 25, to p. 148, line 11.] After he bought the conveyor he had a plate or riser welded on to the hitch end by a welder, Witness Annan. This raised the lower or hitch end of the conveyor 18 inches or more. The hitch was also lowered on to this plate a distance of 12 inches or more. Weigart is not an engineer. He had no advice except from Annan. [Rep. Tr. p. 144, line 22, to p. 145, line 12.] (There was a dispute as to whether the riser was thirty inches in height because the pictures in evidence and the amount of metal used by Annan in installing the riser were seemingly inconsistent with some of the oral testimony.) After the riser was installed and before the time of the accident in which Herbert Young was killed, the conveyor was negligently turned on to its side on two occasions while being care-

lessly backed when connected to a truck, which caused the conveyor to jack-knife and upset. The conveyor was damaged extensively on one of these occasions. [Rep. Tr. p. 136, line 22, to p. 139, line 1.] The repairs were made by Mr. Annan and were not checked by any engineer or tests. Weigart also took the conveyor to Annan on several occasions to weld it. He does not remember how many times but it was less than five. [Rep. Tr. p. 144, lines 3-21.] At the time of the accident the top of the conveyor was raised 20 feet high. It was stable at that height. [Rep. Tr. p. 175, lines 4 and 5.] The motor had been removed with the boom still in the air 20 feet. This lightened the lower or hitch end by 100 pounds. [Rep. Tr. p. 105, line 10, to p. 106, line 6.] Weigart had instructed his men to lower the conveyor to a 15 or 20 degree angle before moving it and not to move the conveyor while the boom was up. [Rep. Tr. p. 43, line 23, to p. 44, line 7.] For reasons of safety, the men customarily would move the conveyor out a foot or two and then crank down the boom till it had no clearance and then repeat till the boom was lowered. [Rep. Tr. p. 104, line 4, to p. 105, line 9.] The deceased pulled the conveyor back one step and then lifted the hitch he was holding and turned the conveyor a 45 degree angle while lifting the bottom of the riser till it was waist-high and the conveyor was parallel to the street. [Rep. Tr. p. 54, line 10, to p. 55, line 8.] The height to which the hitch end of the conveyor was raised while the boom was still elevated, coupled with the removal of the weight of the engine, caused the conveyor to over-balance. The boom end came down rapidly until it hit the ground with a crash. This impact caused the formerly lower end to collapse onto the hitch, pinning Mr. Young between the hitch and the axle and causing his death. [Rep.

Tr. p. 23, line 4, to p. 24, line 18.] Following the accident, Mr. Weigart, called Mr. Yundt on the phone at Roofmaster, where he was then working, and told him that an accident had occurred. At that time Yundt was no longer working for Aeroil and had no connection with Aeroil, which Weigart knew. Yundt notified the Manufacturer Mulkey of the accident. [Rep. Tr. p. 81, line 19, to p. 83, line 2.] Other than this phone call there was no notice of breach of an alleged warranty. There was no pleading of notice of breach of warranty in the complaint. The conversation between Weigart and Mr. Yundt was not received against Aeroil when an objection was made that it was not binding on them. [Rep. Tr. p. 135, line 12, to p. 135, line 17.] Appellants have not cited this ruling as error or stated any specification of error in regard to it. Plaintiffs have not attempted to prove any negligence in so far as Aeroil was concerned. They are basing their claim on alleged breach of warranty in so far as defendant Aeroil is concerned. There is no claim that the conveyor was purchased by the deceased or that any specific warranties were made to deceased. The only claimed representations made by Aeroil are the brochures which are contained in Plaintiffs' Exhibit 6. The Aeroil brochure [Ex. 6] contained no representations which were not directly copied from the Mulkey brochure [Ex. I]. The only expert testimony was that of Mr. Wood, called by plaintiffs. He testified that in his opinion there was a defect in design in the conveyor. That although it was stable when the boom end was elevated and was also stable when it was lowered for moving, if, and only if, the hitch end were raised sufficiently high when the boom was elevated to cause the center of gravity to go beyond the axle the boom end would descend and hit the ground

with a crash and that this crash would be sufficient to cause the hitch end to collapse onto the axle. [Rep. Tr. p. 171, line 21, to p. 178, line 9.] He testified that the welding of the riser on the hitch end of the conveyor changed the vertical center of gravity towards or nearer to the axle. The greater the height of the riser the greater the change would be. [Rep. Tr. p. 211, line 22, to p. p. 215, line 14.] Likewise the horizontal center of gravity was changed to a point closer to the axle by the addition of the riser. This change would increase in relation to the height of the riser. [Rep. Tr. p. 215, line 19, to p. 221, line 1.] The fact that the lower end of the boom was higher with the riser on it produced the result that to get the upper end to the same level of 20 feet the boom had to be raised to a greater angle which caused the struts supporting the boom to be at a steeper angle and which reduced the amount of motion needed to cause the conveyor to tip. [Rep. Tr. p. 222, line 10, to p. 223, line 9.] Mr. Wood did not observe whether or not the boom was in line or what welds had been made on it. He did not see the riser which had been removed by Weigart prior to his examination. Wood also did not check to see if the conveyor complied with the dimensions in the brochures. [Rep. Tr. p. 201, line 11, to p. 208, line 2.] Wood admitted that the natural way to lift the hitch end of the conveyor is by the hitch. He does not know how much the hitch was lowered when it was moved onto the riser. [Rep. Tr. p. 227, line 10, to p. 227, line 22.] One lifting an object is likely to raise it to where one's arms are more or less in height. With the riser on, one would be likely to raise the conveyor that much higher due to the lowering of the hitch. [Rep. Tr. p. 229, line 20, to p. 230, line 12.] If there were

no riser one would have to lift the hitch end of the conveyor three feet, four inches, above the ground to get to the balance point. [Rep. Tr. p. 238, line 18, to p. 236, line 3.] With an 18 inch riser if the hitch end were raised two feet, eight inches, it would reach the balance point. Mr. Wood did not consider the effect of the removal of the one hundred pound engine in his answer. This would have made the difference even greater. [Rep. Tr. p. 234, line 1, to line 11.] The higher the riser and the lower the hitch the greater is the hazard of raising the hitch end too high. [Rep. Tr. p. 237, line 24, to p. 238, line 2.] The above statement contains some of the more important testimony given at the trial of this action. As stated previously it is the contention of the appellees that it was the burden of the appellants to set out all of the testimony in order to establish the fact that the findings of the court were not supported by the evidence. However, since appellants have not seen fit to do so, without waiving appellees' right to object to the form and sufficiency of appellants' specifications of error and of their brief, appellees are hereby setting out a condensation of the testimony of all of the witnesses as to the happening of the accident, with appropriate transcript references. In so far as Wood's testimony is concerned, a great portion of it is of such a technical nature as to make it most difficult to understand without being able to see his diagrams and gestures, coupled with his demonstrations with the scale model. While the testimony was clear in court for the Judge, it is almost impossible to clearly condense here. For that reason appellees have merely set out the conclusions, opinions and admissions of Mr. Wood in his examination and cross-examination, with transcript references.



### Statement of the Evidence.

Exhibit 1. The Mulkey Brochure was admitted in evidence but not necessarily as against all of the defendants. Other circulars of no significance were introduced as Exhibits 2, 3, 4 and 5, and the Aeroil Brochure was admitted as plaintiffs' Exhibit 6. [Rep. Tr. p. 8, lines 2-24.]

Lawrence George Bartlett, called by plaintiffs, testified as follows. He is a newspaper photographer. He heard about the accident over the radio and immediately went to the scene and took pictures. These pictures were introduced into evidence as Exhibits 7 to 13 inclusive. [Rep. Tr. p. 9, line 10, to p. 11, line 7.] According to his best memory, as refreshed by the pictures, a bumper jack and brute force were used to remove Mr. Young from the machine. He also took the picture which was attached to Mr. Baker's deposition. [Rep. Tr. p. 11, line 8, to p. 14, line 18.]

Mr. Lemoine Arthur Thomas testified for plaintiffs as follows: That in July of 1953 he was employed by H. L. Weigart as foreman of the roofing crew. He knew Herbert Young, who went to work for Weigart about July 1, 1953. On July 7th the conveyor was first brought on to the job. He and Herbert Young were present at the time. He saw Exhibits 1 and 6 on that date. [Rep. Tr. p. 14, line 20, to p. 16, line 13.] Mr. Weigart called his employees together and explained the machine to them. He showed them the folders as to the operation. He saw Herbert Young, who was present, read the Brochures. He and decedent continued to work for Wiegart until March 3, 1954. On that date he went to work at 7:00 A.M. Herbert Young went to work even earlier, since he brought the truck and conveyor

from Pomona. At the time of the accident Thomas was on the roof of the next house south of the house where Young was working. The buildings were two story block houses with the garage underneath. The back of each house was on the bank. The road was approximately level, very good, very smooth. There were no obstructions that he could see. There were curbs but no sidewalks. [Rep. Tr. p. 18, line 12, to p. 21, line 13.] Roy Baker was working with Herbert Young. Thomas could see Young. He and Baker were using the Mulkey conveyor to load the roof with rock. Thomas did not see them place the conveyor up on the roof but he saw them loading. Baker was on the ground putting the sacks of rock on the conveyor and Herbert Young was taking them off on the roof. The street was narrow and the conveyor was set at an angle to the street. There was approximately six inches' clearance between the elevator and the edge of the roof. [Rep. Tr. p. 21, line 14, to p. 22, line 25.] The upper end of the conveyor was about knee-high off of the roof. There was a gasoline engine on the conveyor at the bottom or hitch end on the side next to the gear box which moved a chain with clips on it, to move the material up. Herbert Young climbed down the conveyor boom. He saw Young and Baker remove the motor, then they set it on the back of the truck. Then Herbert Young turned around to the conveyor, picked it up several inches, took one step back and swung to his right, and in doing so raised the bottom of the conveyor waist-high. Thomas saw the upper end of the elevator descend very rapidly and Young was hanging on to the hitch end, which was going up into the air, in a curled down position. He went up about as high as the top of the roof. Then the top end of the conveyor hit the ground with a crash and the conveyor



came down in a whip fashion and Young was caught between the hitch and the axle. This took three to four seconds. [Rep. Tr. p. 23, line 1, to p. 24, line 19.] He called Herbert Young's brother and ran to the scene. Baker was already there. Young had been handling the machine the way that they customarily handled it. After the accident Herbert Young was in the position shown on Exhibit 7.

On cross-examination, Thomas testified that Herbert Young had been working for Weigart six or seven months before his death. Mostly Young handled this particular conveyor. Baker was helping him that day. Sometimes Young moved the conveyor alone but it is a two-man job loading it. The top of the roof they were loading was about eighteen feet above the street. All of the roofs were about the same height from the street. The conveyor was set at about the angle where the roof of the garage joins the roof of the house itself. [Rep. Tr. p. 24, line 20, to p. 28, line 20.] The top of the boom was about knee-high above the roof, which is the easiest level to lift off the load. Thomas was on the next house. He was standing at the ladder and had just lowered a bucket for more asphalt. He watched Herbert Young from the time that he started down from the roof until the accident happened, a period of about four minutes. Nothing in particular drew his attention to Young. Young walked down the cleats of the conveyor. Baker was waiting at the bottom. The conveyor was at about a 45 degree angle to the street. The top was at the joint where the roof of the house met the roof of the garage. If you looked at that house the garage would be to the right. It projected out about 10 feet. The top of the boom was about 10 feet further from the street than the front

of the garage. [Rep. Tr. p. 28, line 21, to p. 32, line 23.] When Young climbed down the conveyor boom a part near the top was leaning against the roof. When Young came down he helped Baker take off the engine and set it on the rear of the truck. They removed a block to loosen the belt and take off the motor. The arm that had been there originally had been broken. Thomas did not remember how long before. The conveyor, at the time of Young's death, was different from the brochure because Weigart had had two pieces of 18 inch sheet iron welded to the front of the conveyor and had had the hitch lowered. The 18 inch iron sheets were to raise the bottom of the elevator 18 inches from the ground. This made it easier to load on to the conveyor from a truck. The riser was installed about two weeks after the conveyor was purchased. [Rep. Tr. p. 32, line 24, to p. 35, line 6. ] A welder in Pomona did the job. The installation weighed about thirty pounds. It was a permanent installation. The arm to hold the engine was broken after the riser installation. The truck was about eight feet from the conveyor. Both Young and Baker carried the motor to the truck. The accident occurred three or four seconds after Young got to the ground. He saw Young take hold of the conveyor hitch, raise it up about three or four inches, take one step back, swing to his left and raise the hitch waist-high. The trailer hitch was on the riser. [Rep. Tr. p. 35, line 7, to p. 38, line 23.] When Herbert Young raised the hitch end of the conveyor the top of the boom was in the same position it had been in, not resting against the roof but clear of the roof. When Young took one step back he moved the conveyor back, and then leaving the top of the boom at the same height he swung it to his left, clockwise, so

that the conveyor was parallel to the curb. The top swung over the garage roof. Young turned it about a 45 degree angle before he was lifted off the ground. There was some rock on the street that had been spilled on the street. [Rep. Tr. p. 38, line 24, to p. 42, line 11.]

If there were any obstructions, Young usually moved the conveyor that way. He could have pulled the conveyor back a foot or two and then lowered it until it came into contact with the roof and then pulled it out again. Thomas did not know how Baker did it. He had never seen Baker and Young move it back in that fashion. When he saw Young move the conveyor he would usually turn it parallel to the street and then lower the boom to move the conveyor to another location. He does not recollect seeing Herbert Young move the conveyor with the boom still up. [Rep. Tr. p. 42, line 12, to p. 43, line 25.] The instructions were to always lower the conveyor boom down to a fifteen or twenty degree angle, or lower, before moving it. Those were the instructions that were always given in connection with that conveyor. He had seen Herbert Young move the conveyor in the same way before but never saw him carried up into the air. Young was hanging to the hitch as he was in the air. He was lifted high enough so that he could see daylight between him and the house to the back. The conveyor boom is 32 feet long. The axle is close to the lower end and that is the way it was at the time. He is not sure if the conveyor was parallel to the street when Young was lifted into the air. The flat metal on Exhibit 13 is the riser he was referring to. It had been there for some months before the accident. It raised the lower end of the conveyor 18 inches from the ground. Thomas broke the arm which had held the engine in place by back-

ing into the conveyor with an automobile. The impact knocked the conveyor over. [Rep. Tr. p. 44, line 1, to p. 48, line 1.] The automobile was attached to the hitch and caused the conveyor to jack-knife and turn over. Two bolts were broken in the boom. It was repaired. He does not know if it was damaged other times before the accident to Young. James Young, the deceased's brother, was there at the time of that accident. A bolt here and there on the conveyor had snapped when the conveyor had been turned over before the Young accident, and the axle had a slight bend in it. This was the only Mulkey conveyor Weigart had.

Thomas testified on redirect examination. The conveyor that time was on a slight rise and when he backed it, it tipped over on its side. It did not collapse at that time. In order to lower the conveyor before turning it you would have had to have pulled it back about 8 to 10 feet. He had operated the conveyor and relied on the statements he had seen in the advertising as to how to operate the conveyor. [Rep. Tr. p. 48, line 4, to p. 53, line 25.] The only instructions that Thomas had had as to operating the machine were in the brochures.

On re-cross-examination Thomas testified Young picked the hitch on the conveyor up about three to four inches and then when he started to turn to the left he raised the hitch about waist-high. The bottom of the riser was about waist-high. The carriage of the conveyor is not on a swivel. The whole conveyor turned when Young turned it. When it was parallel to the curb the top of the boom commenced to descend, lifting Young up. [Rep. Tr. p. 54, line 1, to p. 57, line 9.]

James Alexander Baxter, called by plaintiffs, testified as follows: He was an electrician on the job. He saw

the accident happen. He was at the meter box, working on the corner of the house that the conveyor was on. The accident was about 9:00 A. M., or a little after. He saw Young pick up the trailer hitch with both hands, in a bent-over position, move it to his left, take about three steps and then raise the hitch up. It seemed Young was raising the hitch up as he was stepping to his left. Baxter then saw Young go up in the air. The upper end of the conveyor descended very rapidly. Young held on until the top of the boom hit the street. Then Young lost his handhold and fell. Immediately the trailer under-carriage collapsed and fell on him. Young was holding on with his hands above his head and his legs drawn up. [Rep. Tr. p. 57, line 16, to p. 59, line 25.] The street was about level. Baxter could not see the top of the conveyor from where he was working. He did not know Young personally. He had seen roofers move the machine before but does not know if Young was one of them or not.

On cross-examination Baxter testified the house they were working on was No. 744. On those houses the roofs were all about the same level from the street. The conveyor was set at between a 35 and a 45 degree angle from the street. He could not see the top but the left wheel of the conveyor, the one closest to the curb, was about 8 feet from the curb. The wheels, of course, were at the same angle as the conveyor. Baxter did not see where the other man was. The back of the truck was about 10 feet from the conveyor hitch. Young was about five foot ten in height. [Rep. Tr. p. 60, line 1, to p. 65, line 18.] Baxter does not know how far Young leaned down to pick up the hitch. Young was in the act of turning when Baxter first saw him, and was straight-



ening up. Part of the conveyor was approaching the curb as Young turned. Baxter did not notice which wheel or wheels were moving, or if either came into contact with the curb. Baxter left right after the accident. He did not see anyone put anything into the street. He does not know how the wheels moved when the conveyor collapsed. He does not remember a rock or brick as shown in pictures Exhibits 7, 11 and 12. It was muddy there.

Examination by the court: The boom end of the conveyor came down. Young was lifted up about ten feet. When the boom end hit the street it made a terrific jolt or jar. Young lost his handhold and fell with his head across the axle and the hitch fell right over him. Young was not touching any part of the conveyor as he fell. Baxter did not see how the carriage moved. [Rep. Tr. p. 65, line 19, to p. 70, line 25.] It was stipulated that the roof was about seventeen to eighteen feet above the street. [Rep. Tr. p. 71, lines 21 to 26.]

Deryl S. Yundt, called as a witness by the plaintiffs pursuant to Rule 43(b) of the Rules of Civil Procedure, testified that from sometime in 1949 to July 7, 1953, he was Pacific Coast manager of Aeroil Products Company. He managed principally the Los Angeles office, but also the San Francisco and Seattle offices. He did the buying and had charge of the employees of Aeroil. He was paid a salary. In July of 1953 he also owned 50 per cent of Roofmaster. He sold Roofmaster products to Aeroil and in some instances purchased from Aeroil for Roofmaster. [Rep. Tr. p. 73, line 7, to p. 75, line 9.] He has seen similar brochures to plaintiffs' Exhibits 1 to 6. Exhibit 6 is a catalogue of roofers' equipment put out by Aeroil Products Co. That catalogue was

primarily a mailer mailed out as advertising material. The Aeroil Mulkey All Steel Portable Conveyor is on the last page. Plaintiffs' Exhibit 1 is a brochure which was put out by the Sam Mulkey Co. in Kansas City. He carried that in his brief case as advertising for the Mulkey Conveyor. A copy was not delivered with each machine purchased. Ordinarily it was Exhibit 1 that was delivered with each conveyor, though Exhibit 6 could have been given out if they were short of copies of Exhibit 1. [Rep. Tr. p. 75, line 10, to p. 79, line 6.] He does not recall any statements at all made to Mr. Weigart concerning the sale of the machine involved. Though he does remember that one was sold to him. He assumes he made no statements, but he may have given the advertising material (probably a copy of Exhibit 1) with the machine or handed it to Mr. Weigart. Every customer was verbally given an instruction that the machine was only to be moved in down or towing position. He is quite sure he made such a statement to Mr. Weigart. In his deposition he said there were no statements to that effect in the advertising and that he does not remember making such a statement to Weigart. He cannot remember the conversation with Weigart. [Rep. Tr. p. 79, line 19, to p. 81, line 18.] Weigart called him the day of the accident, or the following day. (An objection was made by Aeroil to this question and the court admitted it but stated that the conversation would not be binding on Aeroil unless connected up with them.) Weigart told him that there had been an accident. He told Weigart that he could not get out to where the conveyor was and in fact that he was no longer employed by Aeroil, which had made that sale. He was selling conveyors at the time and he notified the manufacturer



Mulkey of the accident. Prior to delivery, Aeroil checked to see that the conveyor was put together properly, that the under-carriage was in proper position and that the winch assembly was properly assembled. That was done on every conveyor. Aeroil did not conduct any engineering tests in Los Angeles. [Rep. Tr. p. 81, line 19, to p. 83, line 23.] The statements in the brochure that were put out were statements from the Mulkey brochure that were given to them. Aeroil handed them out without making any investigation. The conveyors were brought to them in a knocked down condition. The Los Angeles office assembled the under-carriage, put the bolts together and placed the under-carriage underneath the main part of the conveyor, attached the cable and the hitch, the gear box and the motor base, then operated the conveyor to make sure it was in running condition, and delivered it to the customer. [Rep. Tr. p. 83, line 24, to p. 85, line 25.] They did no fabrication in Los Angeles. On July 7, 1953, he was acting for Aeroil only and not Structural Materials. Structural Materials was simply a billing and invoicing factor in the sale. Technically, Aeroil sold to Structural and Structural sold to Weigart. Structural received a differential in prices for their services as billing agent. Exhibit 6 was received from Aeroil's main office. Exhibit 1 was sent from Sam Mulkey Co. in Kansas City, Missouri. Exhibits 1, 2, 3, 4 and 5 were also handed out to prospective purchasers along with the machine.

Examination by Mr. Ives: He severed his connection with Aeroil officially November 1, 1953. After that he had no further connection with them. [Rep. Tr. p. 86, line 2, to p. 89, line 7.]

The deposition of Roy Baker was then read into evidence by plaintiff. Baker testified that he is a shingler and has been in the roofing business for about sixteen years. He is thirty years of age. He knew all of the Youngs since he was a kid. In March of 1954 he was working in Pomona for Weigart, and had been working for him for four or five months. He was pretty well a flunky. He worked on a hot pot crew, loaded the roofs and did just about everything. He and the Youngs were working for Weigart on that day in Monterey Park. Herbert Young was a roofer, he worked on the hot pot, drove a truck and loaded roofs. The truck was a '48 Chevrolet. It had a home-made hitch on the back of it that was put on by a welding shop in Pomona. It was dropped down low to pull the conveyor so it would be level. [Rep. Tr. p. 91, line 16, to p. 94, line 18.] Herbert Young loaded roofs. They used two types of loading, the conveyor and loading by hand. Young directed both types. In loading by hand they backed the truck as close as possible to a building and threw the marble up on top. In loading by conveyor they backed the conveyor up to a building, raised the boom up, backed the conveyor up and leaned it against the top of the building, having the upper end a comfortable height, about to your belly, above the roof. Weigart had only one conveyor—he did not know the name of it. Baker had never seen any literature of any kind or publications with reference to the conveyor until after the accident. Nor had he ever seen any in the possession of anyone else around the job. [Rep. Tr. p. 94, line 18, to p. 95, line 23.] Weigart had that conveyor before Baker went to work for him and had it the entire time until the accident. James Young had been a shingler and was made

a foreman before the accident. Two guys besides Herbert Young used the conveyor, Baker did not remember their names. Neither of them was working at the time of the accident. It took two to run the conveyor except when Herbert Young was running it. Baker had run the conveyor but never without someone else's help. He had seen Herbert Young load five houses a day with the conveyor during the course of several months. The accident happened on a typical California day. It was not raining. They were loading with the conveyor on that day because it was a two story house. [Rep. Tr. p. 95, line 24, to p. 98, line 11.] He and Herbert Young were using different colored materials and Young had loaded the truck so that they would come off just right. The conveyor was already at the job when Baker arrived. He did not know if the deceased had brought it or not. The accident happened on the third house that they were loading. The houses were built up into the side of a hill. He does not remember if the street was level. The paving was new. The garages stuck out from the front of the houses. Sometimes they would be on one side and sometimes on the other. The conveyor was placed against the garages that stuck out the farthest. Young would back the truck as close as possible and then back the conveyor into place. When they moved the conveyor from one house to another the boom would be down so that it was approximately level. [Rep. Tr. p. 98, line 12, to p. 101, line 25.] After it was in position next to the house he and Herbert Young would crank the conveyor until the top of the boom was belly high above the roof for convenience. The bottom of the boom was about two feet above the ground. He and Herbert Young took the motor off when they were going to move the conveyor.

When he was there they used blocks to tighten the motor. There were supposed to be bolts but there were none on the conveyor when the accident happened. They had been broken off before. When the conveyor was horizontal the hitch on the conveyor was the same height as the hitch on the truck. Once the conveyor was in position it was left there until the roof job was finished. He and Herbert Young raised and lowered the conveyor by moving it a little and then cranking it up or down and then moving it again. Baker never pulled the conveyor far enough out from the house so that the boom could be lowered the whole way at one time. Baker did not believe he ever saw anyone do it that way. They always lowered the boom in stages toward the garage or house for reasons of safety. [Rep. Tr. p. 102, line 1, to p. 105, line 9.] When Young was killed Baker was about three steps away. Baker had taken the motor, which weighed about 100 pounds, off the conveyor at the request of Young, and Baker was about to put the motor in the truck when he heard the boom fall. When Baker took the motor off the conveyor the boom was up fully extended. Baker's attention was attracted by a crash, not very loud at that, and he ran to the conveyor and tride to lift it off of Young before he saw what had happened. [Rep. Tr. p. 105, line 10, to p. 106, line 21.] When Baker last saw the conveyor before it fell it was sort of catercornered toward the garage, not square with it. When he first saw the conveyor after the accident it was not moving. It was parallel with the street. The conveyor had jumped back towards the truck about ten feet. He and Young were the only two of Weigart's men on that house. There were a couple of crews mopping further on down the street. The foreman, whose first name was Leroy, was up on the roof of a house

about five houses down. There was an electrician nearby. He had seen the conveyor collapse once before, about two months before Young was killed. [Rep. Tr. p. 107, line 2, to p. 109, line 17.] Herbert Young and his brother were both there at the time. The conveyor fell over sideways. It had to be picked up and put on the truck. The conveyor was taken to a welding shop in Pomona. James and Herbert Young had a few words about it. James said that Herbert had let the truck roll, tipping the conveyor. Herbert said he did not. He heard the conversation. All of the roofers were present at the conversation. Baker had taken the conveyor to a welding shop before this occurred. It had been welded all over before it fell over. Baker did not know how many times it had been welded but you could see that it had been. Baker helped to move the conveyor but not too frequently. He did not like to work on it. [Rep. Tr. p. 109, line 18, to p. 112, line 16.] The procedure he had mentioned before raising and lowering the conveyor in stages was the way Baker had seen the conveyor moved every time it was moved. It was also the way it was moved everytime that Herbert Young moved it. Baker took it for granted that that was the proper procedure. Herbert Young was in charge of the conveyor when Baker was working on it. The conveyor was always the same length. Baker marked B-1 on the picture Exhibit A as the house where the accident occurred. The conveyor in the picture looked like it did after he heard the crash. The electrician shows in the picture. The roofs on the different houses were all about the same height from the street. With the conveyor at an angle you could pull it out and lower it without obstructing all of the street. At the angle it was set at the



time of the accident it would only obstruct about one-half of the street. Baker did not know what Herbert Young was doing from the time Baker took the motor off. Baker did not see the boom fall. [Rep. Tr. p. 112, line 17, to p. 115, line 19.] He was not present when Young's body was removed from the conveyor. He had taken James Young home. When Baker took the motor off the conveyor Herbert Young was standing with one foot on the bar of the conveyor. Herbert Young was not looking down underneath the conveyor. Young was standing straight up. When Baker said it was safer for two men to move the conveyor he meant that when you put it in the air about half the conveyor is aluminum and it was flexible. It would move around. A man just gets scared of it. Baker didn't necessarily mean that it was dangerous, he personally just didn't like to fool with it. Baker never heard Weigart say that one man could handle it and operate it. Baker never heard that until after the accident. Baker was scared of the conveyor. He is not a brave soul. Baker likes to load his roofs by hand like they do it in Texas. The picture seems to be the conveyor and the surroundings there. The picture was offered in evidence as Defendants' Exhibit A. [Rep. Tr. p. 115, line 20, to p. 118, line 10.]

Lowell E. Annan, called by plaintiffs, testified as follows: He is a welder and did welding for Weigart. He welded the plate on the lower end of the conveyor. He welded it on and reinforced it and lowered the hitch. It would weigh a few pounds over twenty pounds. Mr. Weigart had this particular conveyor in a few times to have it welded. Annan did not recall how many times. He did not know the over-all weight of the conveyor.

On cross-examination Annan testified: He did not check to see when he put the riser on the conveyor and does not remember when it was. He was served with a *subpoena duces tecum* by defendants. He does not know how high the riser was. When he put on the riser he lowered the hitch onto the riser. He lowered the hitch a good twelve inches, at least. He welded an eye to the main section of the riser and bolted the hitch to that section with a one-half inch bolt, and welded it on. [Rep. Tr. p. 118, line 16, to p. 122, line 2.] The hitch had not been welded before. He did not change it except to lower it. He had done work before on the stiffeners on the truss section of the conveyor. It is hard to recall how many times. The conveyor is lightly constructed. The stiffeners did break from road shock and possibly from metal fatigue. It would be safe to say he had welded the stiffeners before the accident at least two times. [Rep. Tr. p. 122, line 3, to p. 123, line 22.] Before the time Young was killed Weigart sent the conveyor in once (to the best of his memory). They said that it had fallen over. Annan straightened the frame some, the first time it had been turned over. It had bent back of the carriage. He straightened it up. He applied heat and pressure at that time. He had to straighten all the members up. There is some deflection in these conveyors just from the weight. He brought the conveyor up to what he is sure it was originally, merely by looking at it.

Examination by the Court: These members in here would break at the angle iron here and the other stiffeners that come down to make cross section would also break and that is generally what he welded. Plaintiffs' Exhibit 9 gives a better view. The hitch originally was attached to the conveyor itself, to the boom. He added the



vertical braces and the horizontal section and attached the hitch to the plate. [Rep. Tr. p. 124, line 10, to p. 129, line 19.]

Harmon L. Weigart called on behalf of the plaintiffs testified as follows: He employed Herbert Young in July of 1953. He remembers bringing the conveyor to the job. He had brochures, Exhibits 1 to 6, and he showed them to Herbert Young. He went over them with all the employees. Young worked for him steadily from that time until he was killed except when it rained. Weigart had the plate installed and the hitch lowered within a month from the time that he bought the conveyor. He received a brochure like Plaintiffs' Exhibit 1 from Roofmaster. He produced it and it was marked Plaintiffs' Exhibit 14. He had it when the accident occurred as he remembers he had two of them, this one and the one that had Aeroil on it. The one from Roofmaster was received after he bought the machine. [Rep. Tr. p. 129, line 21, to p. 134, line 11.] Young received pay raises because he was more experienced in what he had to do in roofing. Weigart was not present at the time of the accident. He was told about it and went to the scene. Sometime that day he remembers a phone call to Deryl S. Yundt. He told Yundt that the machine had collapsed and killed one of his employees and that he would like to have him come to the scene to see the machine. Yundt stated that he knew what happened and there was no need of coming out. (This conversation was not admitted as to defendant Aeroil as it was held as not binding on any defendant not coupled up with Yundt.) When Weigart purchased the conveyor he relied on the statements as to how it was to be used and that one of his employees could handle and operate the

machine and he relied on the advertising matter that he showed his employees. [Rep. Tr. p. 134, line 12, to p. 136, line 20.]

Weigart testified on cross-examination: He does not remember how many times he had welding done on the conveyor before Young was killed. Annan did the repair work. The conveyor had fallen over on its side twice before Young was killed, once at Santa Ana and once at Monterey Park. Once Thomas was driving the truck, or so Thomas said. Annan did the repair job that time. The second time was at the Kimball tract. Annan also repaired the conveyor then. It was loaded on a truck and taken to the welding shop. He does not remember when this was with reference to the accident when Young was killed. Weigart went over the brochures with his men and told them how to raise and how to lower the conveyor and how to put it into position. He said to pull it away from the building before lowering it. He said to lower it first before moving it. He also said never to move the conveyor while the boom was raised except to move the conveyor from the house far enough so that it could be lowered. Those were the instructions he gave all of his employees, including Herbert Young. [Rep. Tr. p. 136, line 22, to p. 141, line 4.] Weigart had been familiar with the Mulkey conveyor for quite some time. He first went into business for himself in 1952. Before that he was in the roofing business with the Bennett Roofing Company. While he worked for them he had occasion to use a Mulkey Conveyor and was thoroughly familiar with the use of a Mulkey Conveyor. He had also used other types of conveyors. When he went into business for himself he was thoroughly conversant with the operation of a

Mulkey conveyor and how it was built, what it would do and how it was used. The same was true with reference to other conveyors. He knew Yundt before he went into business for himself and he was in there quite often. He had talked to Yundt about Mulkey conveyors while he was working for Bennett. [Rep. Tr. p. 141, line 7, to p. 142, line 23.] When he went in to purchase the conveyor there was nothing different about the conversation than from the conversations he had had before. Weigart told Yundt that he wanted a Mulkey conveyor because he knew Mulkey conveyors from previous experience. The reason he bought one was because he liked it better than the other kinds he had used. When he went in it was to get a Mulkey conveyor if he could arrange the credit. He wanted a Mulkey conveyor. [Rep. Tr. p. 142, line 23, to p. 143, line 24.] He was not present at the time of the accident. He does not remember how many times the conveyor was welded other than the times when it had fallen over. He is sure it was less than five times. No one except Annan worked on it after it had fallen on its side. He had no tests made as to whether it was straight, except his eye. Annan put the riser on for him. Annan lowered the trailer hitch at the same time about a foot. They discussed it before it was done. No one else advised them. Weigart is not an engineer, he does not know about Mr. Annan. The boom could not swing from side to side without turning the wheels. He had instructed his men that the boom was to be raised to roof level. He had instructed them that the boom was to be at an angle to the house but not at what angle. The wheels could be on the street or around the house as the case might be. The conveyor can't be loaded unless it is level. Weigart also instructed the men that

when the conveyor is to be moved the wheels were to remain level and not go over rocks or bricks or anything of that nature. He gave these instructions to Mr. Herbert Young. Young operated the conveyor on an average more than the other employees did. On an average Herbert Young would load more than ten houses a week. On that day the foreman had appointed Baker to work with Young. He might have received the Roofmaster brochure through the mail in the late part of 1953 or early in 1954. All of his dealings with Yundt about this sale were at the Aeroil Products Company place of business. Roofmaster was never mentioned. No representations were made to him on behalf of Roofmaster. When he called Yundt after the accident he called him at Roofmaster. When Weigart was working for Bennett he first saw copies of the brochures which are Exhibits 1 to 6. [Rep. Tr. p. 143, line 25, to p. 151, line 14.]

Lowell E. Annan recalled by plaintiff testified further: That he had searched his records and brought the invoices on the Mulkey conveyor that Weigart owned. The plates or riser was installed on August 28, 1953. Annan used three square feet of quarter inch plate, a total of 31 pounds. With the braces it weighed altogether  $46\frac{1}{2}$  pounds. His next invoice was December 31, 1953, when the conveyor was turned over. The conveyor was out of line. Annan re-welded different parts of the conveyor that had been broken from turning over. There were nine hours of work involved. 12 pounds of angle iron were used to reinforce the conveyor and there were sixteen  $\frac{3}{8}$  x 1 machine bolts to replace the bolts that had sheared. There were two  $\frac{5}{8}$  x  $1\frac{1}{2}$  cap screws and hex nuts to replace bolts that had sheared. There were  $2\frac{1}{2}$  feet of  $\frac{1}{2}$  inch pipe which he would imagine were on the

diagonal braces replacing some that had probably broken. After he repaired the conveyor he would say that structurally it was in the same condition it had been before it was turned over. [Rep. Tr. p. 156, line 17, to p. 159, line 9.] His next invoice is January 23, 1954. He straightened and re-welded the conveyor. He straightened its diagonal braces again. They would break loose due to vibration in the use of the conveyor which would move the diagonal brace off the vertical. He would pull them back in and re-weld them. The diagonal braces the cross section of the conveyor because it is the support for the top of the conveyor. That has nothing to do with the under-carriage. There was one hour's work on this job. The next repair bill was February 11, 1954. It was the repairing of and welding of the conveyor frame. That would be those diagonal braces breaking again. That job took twenty to thirty minutes' time. His next invoice is March 9, 1954, after the accident which is involved here. That took one and a half hours. [Rep. Tr. p. 159, line 9, to p. 160, line 22.]

Annan testified on cross-examination: He makes a daily record of all work that goes through his shop. The invoices are numbered and he keeps them in his files in numerical order. If the work is clean and in the open there could be more than one weld made in twenty to thirty minutes. In the nine hour job a lot of time was used in preparing the work. If something is bent it has to be placed on a level and a chain or something applied to put pressure on it and pull it back into normal position. It is hard to establish how many welds there were from the amount of time. There was about ten times as much labor on the job of repairing the conveyor after it had been turned over as there was on the job following the



accident in which Young was killed. It took ten times as much time to repair. [Rep. Tr. p. 160, line 22, to p. 162, line 18.] When he had completed the December, 1953 job, after the conveyor was turned over, from his many years experience in doing that type of work and from looking at the conveyor he could tell it was in its former condition. No measurements were made to see whether the conveyor or the under-carriage conformed to the plans. They did check the hitch from the pulling point back to the axle to see whether the component parts used in towing it down the highway were affected. This would require a check of the carriage the conveyor rests on also because that is a part of the axle. He believes that in 1953 when the conveyor was turned over the pipe in the under-carriage was broken loose where it joined the axle. He applied heat and pressure to the conveyor on the upper portion and he may have applied heat and pressure to the under-carriage also. The invoices were introduced into evidence as Plaintiffs' Exhibit 15. [Rep. Tr. p. 162, line 19, to p. 164, line 25.]

Mrs. Young testified that Herbert Young weighed 142 pounds at the time of the accident. [Rep. Tr. p. 165, lines 13-22.]

David Shotwell Wood called by plaintiffs testified as follows: That he is a professor of engineering at the California Institute of Technology. He was qualified as an expert witness in Mechanical Engineering. He viewed Weigart's Mulkey Conveyor after the riser had been removed. He made some measurements of what he considered to be the pertinent dimensions. He has seen the original of Plaintiffs' Exhibits 1 to 6. [Rep. Tr. p. 166, line 4, to p. 169, line 25.] He has made himself familiar with those aspects of the design of the conveyor

that he considered pertinent to the behavior of the conveyor during the accident. Plaintiffs' Exhibit 16, a model, demonstrates the broad basic features of the conveyor in a qualitative type of way. This model demonstrates the kinetics of the behavior of the machine. He made various measurements of the conveyor in question, particularly the overall length, the length of the articulated members of the under-carriage, and the weight to give him the balancing characteristics of the machine. [Rep. Tr. p. 170, line 2, to p. 171, line 20.] He is of the opinion that assuming the riser had been welded on and the street was a level macadam surface and the upper end of the conveyor was twenty feet high and that the man at the lower end weighed 142 pounds, and that the engine was not attached, and that the upper end of the conveyor hit the street and then that it collapsed as shown in the pictures, that there is a defect in the design which could lead to a collapse as shown by the pictures. In the normal raised or lowered position the conveyor is a stable structure. If the lower end is lifted until the center of gravity of the whole machine is over the axle then it is in what he would call an unstable balanced position and it can fall either way. If it falls over so that the upper end hits the ground with some impact then it will collapse. [Rep. Tr. p. 171, line 21, to p. 178, line 9.] When he examined the machine the plates were not on it. He then gave various measurements and weights. From the nature of the machine it seems apparent that there is a bit more weight toward the rear end because of the gear and the winch. However it is easy to lift the hitch end. Assuming that  $46\frac{1}{2}$  pounds of plates had been welded on it would shift the center of gravity slightly about eight inches to the rear. He never testified as to what



the effect of the engine weighing 100 pounds on the conveyor would be or how much it would change the vertical or horizontal center of gravity. The weight of the man would shift the center of gravity further to the rear. As he lifts the hitch end of the conveyor up, the power needed decreases, until the center of gravity gets directly above the axle and no force is needed to hold it up. According to his calculations, if the machine is raised five feet five inches off of the ground at the hitch end with a 150 pound man holding onto it, it will balance. If the end goes higher than that the man will not be able to prevent it from tipping over. [Rep. Tr. p. 178, line 10, to p. 189, line 25.] As it continues to tip it generates 914 foot pounds of energy which creates a shock when the upper end of the boom strikes the ground. If this energy is sufficient to cause the strut to become vertical the conveyor will collapse. [Rep. Tr. p. 190, line 14, to p. 195, line 19.]

The basis of his statement about the collapse of the machine being due to design is that there is a larger amount of energy available due to the machine tipping over than is required to counteract its stability and leads to a rapid collapse. In his opinion if the 18 inch plate had not been on the normally lower end there would have been some slight but in his opinion insignificant changes. The energy generated by the machine tipping over would be less but still more than needed to cause the machine to collapse. If the rollers were constricted this type of collapse could not occur. [Rep. Tr. p. 195, line 20, to p. 197, line 15.]

Wood testified on cross-examination: The conveyor would only collapse as he has described if it tips over and the top end hits the ground with a crash. This con-

veyor is balanced like an inverted pendulum or see-saw. He examined the conveyor in January of 1956. It was 32 feet in length and he considered the hitch as being 16 inches in addition. When he saw it the hitch was on the conveyor itself and not on the plate or riser. The riser was not on the conveyor. His figures were based entirely on what he was told about the weight and height of the riser. The hitch end is a little heavier than the upper end of the boom. He did not mention the effect of the weight of the engine in this connection. Any trailer is designed so that it will be slightly heavier toward the hitch end. The conveyor is designed to be taken from place to place by the hitch. [Rep. Tr. p. 197, line 14, to p. 201, line 10.] He did not measure the height of the axle off the ground. He took no particular note of welds or work that had been done on the conveyor. One or two were pointed out to him. He does not remember if he was told of any previous tipping over of the conveyor or of the damage due to said tipping. He made no checks to see if the machine complied with Exhibits 1 to 6. He could not have done so as the drawings were not complete enough to permit that. He does not know the height of the bed in a Chevrolet truck. He does not know whether when the conveyor is used to lift loads onto a roof it is customarily leaned against a roof or not. He has never seen one in operation. [Rep. Tr. p. 201, line 11, to p. 208, line 2.] Generally if the conveyor is used without resting the top of the boom on something it would put a good deal more stress and strain on the top of the boom. He made no observation to

see if there had been any twisting or distortion of the boom itself. He cannot tell from the pictures in evidence whether the top of the boom was resting on something or not. One of the factors as to the tipping over of the conveyor is the height to which you raise the bottom or hitch end of the conveyor. If you raise that end high enough so that the center of gravity goes above or beyond the axle it will tip over. If the conveyor was in the elevated position it would be stable. [Rep. Tr. p. 208, line 2, to p. 210, line 3.] His calculations were based on the fact that the lower end of the riser would be on the ground. He calculated the position of the center of gravity with and without the riser. With the riser the center of gravity would be eight feet eleven inches off the ground. Without the riser the center of gravity would be eight feet, six inches, or a difference of five inches. He did not state what difference the weight of the motor would have made. If the riser was higher it would add to the difference. [Rep. Tr. p. 210, line 3, to p. 215, line 18.] The machine can not tip over until the hitch end has been raised a certain distance off of the ground unless a weight is placed on the other end. Besides the vertical center of gravity there is also the horizontal. With the riser on and without the weight of the motor or of a man, and with the top raised twenty feet the horizontal center of gravity is twenty-two inches from the axle on the hitch side. If the riser were not on then the horizontal center of gravity would be five inches further from the axle, or twenty-seven inches. [Rep. Tr. p. 215, line 19, to p. 221, line 23.] The higher the hitch end the

more acute is the angle to which you have to place the struts to get the top to the same level. He cannot tell from the pictures what the height of the riser is. The wheel is twenty-nine inches high and the riser seems higher in pictures taken from several directions. He made no measurements of the height of the riser. [Rep. Tr. p. 221, line 23, to p. 227, line 9.] If he went to lift the end of the conveyor he would take hold by the hitch. It is the only thing that would be convenient to hold on with. He cannot tell how much the hitch was lowered by looking at the pictures. When the hitch is lower a person moving it tends to lift it up into a position where one's arms are more or less in height and the total height of that end of the conveyor off the ground is higher when the hitch is lower with respect to the conveyor. [Rep. Tr. p. 227, line 10, to p. 230, line 12.] The weight of a man lifting the hitch end does not begin to come into play until the conveyor reaches the point of balance. According to his calculations the under-surface of the boom at the hitch end without the riser would have to be lifted to a height of three feet three inches to reach the unstable balance point. He did not say how much higher it would have to be with the engine on. The slant height to the top of the boom would be somewhat under ten inches. With no riser on the operator would have to raise the hitch end three feet four inches to get it to the point where the conveyor would tip forward. With an eighteen inch riser if the hitch were raised two feet eight inches it would reach the point of unstable balance. [Rep. Tr. p. 230, line 13, to p. 236, line 3.]

## ARGUMENT.

### I.

**The Appeal Should Be Dismissed for the Reason That Appellants Have Not Complied With the Rules of the United States Court of Appeals for the Ninth Circuit.**

The appellees urge that this appeal be dismissed for the following reasons:

The appellants did not comply with Rule 18, 2(d) of the Rules of the United States Court of Appeals for the Ninth Circuit. The Specifications of Error are twenty-seven in number. Only numbers I and IX are specifications not taken from the findings of fact and conclusions of law. The specifications do not set out any grounds of error such as error in admission or rejection of evidence. The Specifications XI through XXVII merely state that the findings are not supported by the evidence or are an erroneous conclusion of law.

In *Thys Company v. Anglo California Bank*, 219 F. 2d 131, at pages 132 and 133 the court states:

“The specification does not, as this provision of the rules requires, state as particular as may be wherein the findings of fact and conclusions of law are alleged to be erroneous. Defects in this particular are not remedied by referring the reader to the pages of the brief where the points are argued.

Where as here, the brief for an appellant exhibits a gross disregard of the requirement of our rules, a dismissal of the appeal is warranted.”



## II.

### The Judgment Should Be Affirmed for the Reason That the Evidence Supports the Findings.

Under Rules 52(a) and 46 of the Rules of the United States Court of Appeals this court should not consider the error urged by appellants that the evidence does not support the findings. In *United States v. U. S. Gypsum Company*, 333 U. S. 364, at page 394, the rule is set forth by Justice Reed:

“Findings of fact in action tried without a jury, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses.”

Further, in *Andrew Jergens Company v. Conner*, 125 F. 2d 686, at page 689, where the action was tried by the court sitting without a jury, as in the case at bar, the court said:

“Where a case is tried by the court, a jury having been waived, the court’s findings upon questions of fact are conclusive upon appeal, no matter how convincing the argument that upon the evidence the finding should have been different unless there is no substantial evidence to support them.”

Justice Jackson, in the case of *United States v. Yellow Cab Company*, 338 U. S. 338, at page 342, states:

“Such a choice between two permissible views of the weight of evidence is not ‘clearly erroneous.’”

The appellant in that case appealed on the findings of facts, which the court stated amounted virtually to a



trial *de novo* of the record of such findings as intent, motive and design.

This case involves a mechanical device and questions of fact concerning it.

In *Grover Tank and Mfg. Co. v. Linde Air Products Co.*, 339 U. S. 605, at page 609, Justice Jackson, in discussing this rule states:

“Proof can be made in any form: through testimony of experts or others versed in the technology; by documents, including texts and treatises; and, of course, by the disclosures of the prior art. Like any other issue of fact, final determination requires a balancing of credibility, persuasiveness and weight of evidence. It is to be decided by the trial court and that court’s decision, under general principles of appellate review, should not be disturbed unless clearly erroneous. Particularly is this so in a field where so much depends upon familiarity with specific scientific problems and principles not usually contained in the general storehouse of knowledge and experience.”

Since the evidence in the case at bar is sufficient to sustain the findings of the trial court, and particularly since it involves a mechanical device and the expert testimony of the scientific problems and principles were all before the court, illustrated by gestures, diagrams and the operation of a scale model, it cannot be said that any of the findings were clearly erroneous.

### III.

The Court Did Not Err in Giving Judgment for Defendants by Concluding That There Were No Express or Implied Warranties Available to Plaintiffs; That Privity of Contract of Sale Was Required Between the Deceased, Herbert Weldon Young and the Defendants; That There Was No Breach of Any Warranties Whatsoever; That No Notice of an Alleged Breach of Warranty Was Given and That There Was No Duty Upon the Part of the Defendants to Inspect the Conveyor.

Appellants have chosen to argue all of the above points in Point I of their Argument without breaking down specific points involved. Appellees feel that it is more orderly to divide the various portions of this argument into the separate points as above stated and will discuss each feature separately.

#### A.

There Were No Express or Implied Warranties Available to Plaintiffs in the Above Action Regardless of Any Question as to Privity of Contract.

The testimony showed, without contradiction, that there were no express statements made by the defendant Yundt at the time when he sold Mr. Weigart the conveyor. Weigart testified, as hereinbefore set out in Statement of the Evidence, that he had been familiar with the Mulkey Conveyor for many years and had used this and other types of conveyors, and was thoroughly familiar with their operation. When he contacted Yundt to purchase the conveyor he had already made up his mind as to what type of conveyor he wished to get. He did not rely on any representations of the defendant Yundt or any written advertisement of the manufacturer Mulkey

or defendant Aeroil Products. It is significant that there were no statements contained in the brochure published by the Aeroil Products Company that were not in effect copies of the contents of the brochure of the Mulkey Conveyor Company. This can be determined by comparing the wording of Plaintiffs' Exhibit 1, the Mulkey brochure, with that of Plaintiffs' Exhibit 6, the Aeroil brochure. The Mulkey Conveyor brochure is more complete and goes into more detail. Every statement that appears in the Aeroil brochure also appears word for word in the Mulkey brochure. Certainly the court could well have found, and must have found, under the testimony of Weigart that he brought the conveyor because of his own knowledge of the operation and manufacture and use of the conveyor and without any reference whatever to the advertising. Unless there is reliance upon representations or advertising matter there is no warranty.

Section 1732 of the Civil Code reads as follows:

“DEFINITION OF EXPRESSED WARRANTY. Any affirmation of fact or any promise by the seller relating to the goods is an express warranty if the natural tendency of such affirmation or promise is to induce the buyer to purchase the goods, and if the buyer purchases the goods relying thereon. No affirmation of the value of the goods, nor any statement purporting to be a statement of the seller's opinion only shall be construed as a warranty. (Added Stats. 1931, c. 1070, p. 2238, par. 1.)”

*Burr v. Sherwin-Williams*, 42 Cal. 2d 682, at 696 states:

“(21) The principal elements of an express warranty are an affirmation of fact or promise by the seller and reliance thereon by the buyer.”

*Simmons v. Rhodes & Jamieson, Ltd.*, 46 Cal. 2d 190, at page 193, states:

“(1) Where the buyer, expressly or by implication, makes known to the seller the particular purpose for which the goods are required, and it appears that the buyer relies on the seller’s skill or judgment (whether he be the grower or manufacturer or not), there is an implied warranty that the goods shall be reasonably fit for such purpose.”

If there was no warranty in connection with the sale to Weigart there was no warranty in so far as the plaintiffs were concerned.

Moreover, even had Weigart or Young relied upon any representations in the brochures any warranty that might have existed would have been defeated by the fact that after the sale to Weigart, and long before the accident, the conveyor had been altered and changed in such a way as to completely alter its operation. It had also been considerably damaged in two accidents where it was negligently turned onto its side by Weigart’s employees when they were attempting to back a truck with the conveyor attached and the truck and conveyor jack-knifed. As has been heretofore set out in the Statement of the Evidence (soon after the conveyor was purchased by Weigart) apparently in order to facilitate the handling of material from the floor of the truck bed, which is about thirty inches high, on to the bottom of the conveyor, Weigart had a riser welded to the hitch end of the conveyor. According to Weigart and Annan, the welder who installed it, this riser was eighteen inches high. According to the pictures in evidence it seemed to be at least thirty inches high. This thirty inch height certainly would

place the bottom of the conveyor exactly even with the floor of the truck from which it was being loaded. This had the effect of altering the horizontal center of gravity of the conveyor and of changing the vertical center of gravity. It also placed the struts in the under-carriage at such an acute angle to one another as to greatly increase the hazard of a collapse of the under-carriage. It is obvious that with the riser attached below the bottom of the conveyor and the hitch, by which it was naturally moved, and by which it was being moved by the deceased, being lowered to the bottom of that riser, that a person in moving the conveyor would be inclined to lift the hitch higher than would have been necessary had the riser not been installed. This increased the danger of the operator negligently over-balancing the conveyor and causing the upper end to come down upon the ground in see-saw fashion. This was the very thing which occurred and led to this accident. In addition, at the time of the accident the engine which operated the conveyor and which weighed approximately 100 pounds, had been removed from the conveyor while the boom end was up, which considerably changed the balance of the conveyor. Removal of the engine very much diminished the strength which would be needed by the operator to over-balance the conveyor.

Moreover, considerable damage was done to the conveyor on the two occasions before Young's accident when the conveyor had been negligently tipped upon its side. Repair of this damage required welding of the supports and straightening of the axle. This work was done by Mr. Annan under the supervision of Mr. Weigart. Neither of these gentlemen were engineers. They made no effort to establish whether or not the conveyor had



been replaced into its former size or shape, or to determine whether its balance had in any way been affected. Obviously, had there ever been any warranties as to this particular conveyor they would long before have terminated due to the alterations, misuse, damage and repairs to the conveyor. Among the authorities holding that a change of an article warranted defeats the warranty are the cases of *Collum v. Pope & Talbot*, 135 Cal. App. 2d 653, at page 660,

“In other words, these changes which plaintiffs made in this piece of lumber were such as would seem to make it inequitable for the law to treat it as the very same article which the millowner sold to the dealer and the dealer sold to the contractor, when the urge is to extend an exception to the rule which requires privity of contract. Any express warranty seems clearly precluded by these changes.”

*Kling v. Kimball Pump Co.*, 138 Cal. App. 470, at page 472,

“Respondent took the position that such failure, if any, was caused either by reason of the manner of installation of the foundations for the pump, which foundations appellants were required to furnish under the terms of the contract, or the rapid lowering of the water level in the well or the negligent manner in which the pump was operated by appellants. A review of the record leads us to the conclusion that there was ample evidence to sustain respondent’s claims and that the trial court was justified in finding that said pump ‘has at all times complied with and conformed to all of the warranties, representations and guaranties made by defendant and cross-complainant.’ ”



*Ivancovich v. Bertossi*, 202 Cal. 770, at pages 775 and 776, (1),

“When we consider the evidence of Cassani that mixing the white or muscat wine with the Zinfandel wine would spoil the mixture, together with the other evidence in the case as to the unfavorable results that might result from the blending of wine by the use of a hose or other implements not properly cleaned, we are of the opinion that it was not an unreasonable conclusion or inference for the trial court to draw that the inferior quality of the wine and its unmerchantable character after it was blended was due entirely and solely to the acts of Mooser and his employees in the mixing and blending of the wine. The evidence, therefore, was sufficient to sustain and justify the findings of the trial court in favor of the respondent.”

### B.

**There Was No Privity of Contract Between the Decedent, Herbert Weldon Young, and the Defendant Aeroil Products Company, or Yundt.**

In connection with this appellants have cited three cases. First, the case of *Gagne v. Bertran*, 43 Cal. 2d 481. This is a case which is entirely dissimilar in facts. In the *Gagne* case the plaintiff hired an alleged engineer and geologist to make some cores for him to determine the depth of the fill on some property which the plaintiff was considering buying. The defendant was neither a geologist or engineer. He also carelessly made cores improperly determining the depth of the fill. The decision holds specifically that there was no warranty and that findings based on warranty were not supported by the evidence. Under those particular circumstances the

court held that the defendant was negligent and guilty of fraud and deceit. The case does not support appellants' contentions.

The second case cited by appellants on this point is *Free v. Sluss*, 87 Cal. App. 2d Supp. 933. This is an appeal from a Municipal Court action and deals with the sale of soap by sample. During the soap shortage the defendant manufacturer sold one batch of soap to the plaintiff which was satisfactory. Defendant salesman orally warranted that the second batch would be of a similar satisfactory nature. There was also a written warranty on the wrapper. Judgment in favor of the plaintiff against both defendants was upheld. This certainly does not afford any authority for the proposition on page 15 of appellants' brief to the effect that innocent misrepresentation of fact would support strict liability on the part of the seller. The case is merely a Superior Court decision.

The third case cited by appellants is the case of *Sheward v. Virtue*, 20 Cal. 2d 410. This is a case in which the court holds that the *manufacturer*, even in the absence of privity of contract, has a duty of care if the article manufactured is inherently dangerous, or if it is negligently manufactured, or constructed, or it is reasonably certain to place life and limb in peril. This case specifically does not involve the duty of the retailer. In fact the retailer, Bullock's Department Store, was granted a motion for new trial and the propriety of the court's granting the motion was not discussed in the decision.

In the instant case the conveyor was safe, sound and solid when balanced or raised to the maximum point mentioned in the brochure. The theory of plaintiffs is that if this conveyor is negligently over-balanced so that the

upper end of it violently comes into contact with the ground then the under-carriage may collapse. This is obviously not a negligently manufactured or constructed piece of machinery.

Moreover, there are decisions in California ignored by plaintiff directly holding that there must be privity of contract. One of the cases so holding is the case of *Burr v. Sherwin Williams Company*, 42 Cal. 2d 682, was erroneously cited by appellants as supporting their contentions. It does not do so. Appellants admit, on page 18 of their brief, that the general rule is that privity of contract is required in an action for a breach of express or implied warranty, which is the rule as stated in the *Burr v. Sherwin Williams* case. Appellants correctly go on to state that an exception to this general rule is cases involving food stuffs, and there are many cases so holding in California. However, there is no contention in this case that the conveyor involved food stuffs. Appellants go on to state that there is no requirement of privity of contract in cases where the person using the products relied on representations made by the seller in advertising material and that recovery was allowed on the theory of express warranty. The *Burr v. Sherwin Williams* case does not so state. In that case a judgment in favor of the plaintiff was reversed partially because of certain instructions dealing with *res ipsa loquitur*, but also with reference to instructions on warranty. The court states, on page 695, paragraph 19:

“The general rule is that privity of contract is required in an action for breach of either express or implied warranty and that there is no privity between the original seller and a subsequent purchaser who is in no way a party to the original sale.” (Citing cases.)

Among these cases the court cites and approves *Lewis v. Terry*, 111 Cal. 39, which will be mentioned later in this brief. It mentions that there is a possible exception where the purchaser of a product relied on representations made by the *manufacturer* without a showing of privity. This is not a case where the alleged representations are made by the manufacturer, and in fact the testimony shows without contradiction that the machine was designed and constructed by Mulkey, who did not appear in the above action, and are not involved in this appeal.

The only other cases cited by appellants in this regard are *Gagne v. Bertran*, *supra*, which, as stated before, involves a completely different situation factually, where a man held himself out to be an engineer and geologist when he was not, and where the decision was based on fraud and deceit and not on warranty; and the case of *Edwards v. Sergi*, 137 Cal. App. 369, wherein an owner of property and his brother falsely represented that a piece of woodland was included in a farm which was sold to plaintiff. Neither of these cases remotely resemble the case at bar and they do not support appellants' contentions. Nor do Sections 1572, subd. 2, and 1710 of the Civil Code, which refer to Fraud and Deceit, apply here. It would seem clear that Weigart, who knew and used Mulkey conveyors, would have a much better knowledge of them than the retailer who even according to appellants could not have learned of the alleged defect unless they had tipped the conveyor over with sufficient force to cause the crash to over-balance the conveyor's stability. There was not a word of evidence that this type of accident had ever occurred before or since.

The theory under which various cases, beginning with the New York case of *MacPherson v. Buick*, 217 N. Y.

382, was decided is the fact that the manufacturer might have superior knowledge of a defect than the ultimate consumer and for that reason that he may be held to warranties without privity of contract. The reasoning in these cases does not apply, nor do the decisions refer to the obligation on the part of a retailer. The cases cited by appellants, such as *Kalash v. Los Angeles Ladder Co.*, 1 Cal. 2d 229, are all cases against the manufacturer. The case of *Escola v. Coca-Cola Bottling Co.*, 24 Cal. 2d 453, deals only with the responsibility of the *manufacturer*, not the retailer. Moreover, in many respects it directly supports the contentions of respondents. At page 458 the court states:

“(2) Many authorities state that the happening of the accident does not speak for itself where it took place some time after defendant had relinquished control of the instrumentality causing the injury. Under the more logical view, however, the doctrine may be applied upon the theory that defendant had control at the time of the alleged negligent act, although not at the time of the accident, *provided* plaintiff first proves that the condition of the instrumentality had not been changed after it left the defendant’s possession. (See cases collected in *Honea v. City Dairy, Inc.*, 22 Cal. 2d 614, 617-618 (140 P. 2d 369).) (3) As said in *Dunn v. Hoffman Beverage Co.*, 126 N. J. L. 556 (20 A. 2d 352, 354), ‘defendant is not charged with the duty of showing affirmatively that something happened to the bottle after it left its control or management; . . . to get to the jury the plaintiff must show that there was due care during that period.’ Plaintiff must also prove that she handled the bottle carefully. The reason for this prerequisite is set forth in Prosser on Torts, *supra*, at page 300, where the author



states: 'Allied to the condition of exclusive control in the defendant is that of absence of any action on the part of the plaintiff contributing to the accident. Its purpose, of course, is to eliminate the possibility that it was the plaintiff who was responsible. If the boiler of a locomotive explodes while the plaintiff engineer is operating it, the inference of his own negligence is at least as great as that of the defendant, and *res ipsa loquitur* will not apply until he has accounted for his own conduct.' "

The case of *Lane v. C. A. Swanson & Sons*, 130 Cal. App. 2d 210, concerns an express warranty by a manufacturer that a can of chicken contains no bones and has been boned. Again the reasoning of the decision comes within the warranty exception of Food cases and the court specifically held on page 216 in the last paragraph that it did not consider the question as to the defendant retailer.

"The brief of the defendants does not point out any ground of distinction between the responsibility of Swanson and Sons Food Company with respect to the express warranty. We have not considered that question."

The case of *Tremeroli v. Austin Trailer*, 102 Cal. App. 2d 464, merely holds that a question of fact was presented and that a verdict of the jury could not be reversed where there was evidence of an implied warranty and of reliance by the buyer. It is a case where there was a privity of contract and is therefore readily distinguishable here.



The particular situation involved here has been directly passed on in California in the very recent case of *Collum v. Pope & Halbot, Inc.*, 135 Cal. App. 2d 653 (hearing in the Supreme Court denied). This case is factually directly in point. The defendant was a retailer who sold certain joists to plaintiff's employer. Plaintiff, while in the course and scope of his employment, sustained an injury when some of the lumber broke. Many of the cases cited by appellants were considered in the *Pope & Talbot* decision. The court holds that there was nothing in the case to bring it within the exceptions to the general rule that privity of contract is required before there are any warranties express or implied. In the *Pope & Talbot* case the defendant manufacturer stamped "Grade #1 or better" on some of the lumber. This corresponds to the brochures involved herein. It was contended in the *Pope & Talbot* decision that Cheim, as the dealer, warranted the quality of this joist because of this stamp and that the plaintiff acted in reliance thereon, to his injury. This allegation is identical to the claim made here by plaintiffs that by adopting the exact wording of the Mulkey brochure a specific warranty was made by defendant Aeroil. Certain work was done on the lumber by the defendants, cutting the logs into poles of varying sizes, and the court specifically held that this did not make them manufacturers within the meaning of that word as used by our Supreme Court. Similarly the minor assembly of the conveyor by Aeroil would not in any way make it a manufacturer. In the *Pope & Talbot* case the

lower court granted a nonsuit and denied a motion for a new trial. The Appellate Court held as a matter of law that there was no privity of contract and that no case had been established by the plaintiffs sufficient to warrant submitting the matter to a jury. The court stated at page 656:

“The general rule is that privity of contract is required in an action for breach of either express or implied warranty and that there is no privity between the original seller and a subsequent purchaser who is in no way a party to the original sale.”

The court cited the *Lewis v. Terry* case, 111 Cal. 39, as authority for this proposition and approved the *Lewis v. Terry* decision. The court also apparently referred to the *Burr v. Sherwin Williams* case by mentioning the decision of the Supreme Court as to the privity of contract rule (as recently as April 1954), although that case it may be noted was decided in March 1954.

The *Pope & Talbot* decision has been completely ignored by appellants in their brief. It is the leading case in California on this subject and is directly in point. As was mentioned in that decision there are several older decisions to the same effect, such as the case of *Lewis v. Terry*, 111 Cal. 39, in which, at page 44, the court stated:

“If a tradesman sells or furnishes for use an article actually unsound and dangerous, but which he believes to be safe and warrants accordingly, he is not liable for injuries resulting from its defective or unsafe condition to a person who was neither a party to the contract with him, nor one for whose benefit the contract was made.” (Citing cases from other jurisdictions.)

C.

Had There Been Any Warranties in This Matter and Had They Not Been Terminated by the Repairs and Accidents and Use of the Conveyor Prior to the Accident in Which Decedent Was Killed, There Still Would Have Been No Breach of Warranty in the Above Action.

Appellants glibly refer to various express warranties which they claim were made. These are mentioned on page 6 of Appellants' Opening Brief.

"Aeroil Portable Equipment for the Modern Roofer". It is portable. There is no question about the fact that the conveyor is portable. Certainly there has been no breach of any statement therein contained.

"Look at these Mulkey Features, Balanced and Portable. One man can handle and operate." Respondents respectfully urge that the very meaning of the word "balanced" means that if it is over-balanced the machine will tip over. The word "balanced" connotes the fact that the conveyor can be placed into a position of balance. There was therefore no breach of warranty in that regard. The last statement is "One man can handle and operate." Respondents respectfully urge that there has been no proof whatever to the effect that this was not true. Had the riser not been installed, had the balance not been changed by removing the motor, and had the machine not been damaged by negligent use of it prior to the accident in which Herbert Weldon Young was killed, it could readily have been used and operated by one person alone. In fact had Mr. Young chosen to follow the technique referred to by witness Baker, the accident could not have occurred and Young would have been perfectly able to have handled the machine himself. This accident was not due to the fact that the conveyor could

not be operated by one person. It was due to the conveyor being mishandled by Mr. Young at the time of the accident. This did not constitute any breach of warranty whatsoever.

Certainly the further alleged express warranties "Eliminates Back-Breaking Labor Fatigue" and "will accommodate one 8-foot extension, and operate to a height of twenty-two feet" were all true and the testimony of plaintiffs' expert showed that the conveyor could be used in perfect safety at a height of twenty-two feet and was stable at that height. Likewise the only remaining statement that "the under-carriage moves forward for proper balance" was true.

It must also be borne in mind that the court stated the Mulkey brochure was not binding on the defendant Aeroil. No testimony was later introduced which would cause the Mulkey brochure to be binding on Aeroil. Undoubtedly the court found as a question of fact that the Mulkey brochure was not binding on Aeroil. No exception to his ruling in that regard was made by appellants. Moreover all of the statements in this Mulkey brochure were supported by the evidence.

Appellees respectfully urge that there was no breach of any of the alleged warranties.

#### **D.**

#### **No Notice of Breach of Warranty Was Given to Defendant Aeroil.**

Appellants have not contended that they gave any notice of any alleged breach of warranty. They state that on the day of the accident Mr. Weigart called Mr. Yundt and told him about the accident. Yundt at that time was working for Roofmaster and was no longer in any way

connected with Aeroil. Weigart admitted that he called Yundt at Roofmaster and that he knew Yundt was no longer working for Aeroil. Yundt stated that he notified the manufacturer Mulkey that an accident had occurred. This would certainly not constitute any notice of any alleged breach of warranty to defendant Aeroil. Appellants have alleged that there is no need for notice with reference to a breach of warranty, because of the fact that a warranty action for death is actually a tort action, rather than a contract action. Appellants cite *Prosser Law of Torts, 2nd Edition*, page 493, to establish the proposition that "this type of action is a curious hybrid of tort and contract unique in the law." It is significant that the entire chapter on this subject by Prosser there is no reference whatever to any abrogation of the general law that it is necessary to plead and prove notice of a breach of warranty. Certainly had there been such an exception it would have been mentioned by Prosser. Prosser restricts his statements as to "hybrid action" to three classes of cases. First, that the rule as to survival of a cause of action in a tort case rather than a contract case prevails, citing the case of *Gosling v. Nichols*, 59 Cal. App. 2d 442. The reasoning in this decision is in the interpretation of Section 377 of the Code of Civil Procedure, which specifically states that a tort action abates with the death of the wrong-doer and does not specifically define what is meant by the words "wrong-doer".

Second, that the tort rule as to limitation of actions rather than the contract period applies, citing the case of *Rubino v. Utah Canning Co.*, 123 Cal. App. 2d 18, which holds that the statute of limitations with reference to torts applies in food poisoning cases and again this



is predicated upon the definition in the statutes of the words "wrongful act or neglect."

The third type of cases referred to are those dealing with the measure of damages and again the words "wrong-doer" are used in the statute.

On page 20 of Appellants' Opening Brief they have stated "There is no requirement in law under the rules of tort actions to require the wife or minor children of the deceased to give notice." (Citing *Rubino v. Utah Canning Co.*, 123 Cal. App. 2d 18.) Respondents respectfully suggest that appellants have either deliberately or negligently cited said case as upholding this proposition since a careful examination of the decision does not reveal one single word with reference to the necessity or propriety of notice and the fact of notice is not referred to in any way.

Appellants have neglected to mention cases in California rising out of breach of warranty specifically and unequivocally holding that notice of breach of warranty must be given. The leading case in this regard is the case of *Vogel v. Thrifty Drug Co.*, 43 Cal. 2d 184. This case holds that notice of a breach must be pleaded and provide. At pages 187 and 188 the court states, paragraph 2,

"But in making this argument plaintiff overlooks an element essential to stating a cause of action for breach of the implied warranty, i.e., an allegation that plaintiff gave notice of the breach to the defendant within a reasonable time.

"Section 1769 of the Civil Code provides that 'In the absence of express or implied agreement of the parties, acceptance of the goods by the buyer shall not discharge the seller from liability in damages



or other legal remedy for breach of any promise or warranty in the contract to sell or the sale. But, if, after acceptance of the goods, the buyer fails to give notice to the seller of the breach of any promise or warranty within a reasonable time after the buyer knows or ought to know of such breach, the seller shall not be liable therefor.'

\* \* \* \* \*

"(4) It further appears that 'The clear and practically unbroken current of authority establishes the doctrine that the requirement of notice to be given by the vendee charging breach of warranty is imposed as a condition precedent to the right to recover, and the giving of notice must be pleaded and proved by the party seeking to recover for such breach.' (Citing cases) 'The giving of such notice must be pleaded and proved by the purchaser seeking to recover or defend for the breach of warranty'; 77 C.J.S. 1276, 'Where the buyer must give notice of the breach of warranty, his plea or answer setting up a breach of warranty must allege the giving of the necessary notice within the proper time, or a waiver thereof by the seller. The giving of notice must be pleaded clearly and without ambiguity . . .'; 46 Am. Jur. 439, 'The burden is upon the one claiming the breach of warranty to plead and prove notice within a reasonable time'; see also *Bailey Trading Co. v. Levey* (1925), 72 Cal. App. 339, 345 (237 P. 408)."

The *Vogel* case arises out of warranty in a food poisoning case and is directly in point with the case at bar. Even without any of the other points involved in this appeal it would be an ample support for the court's decision as in the case involved here there was no pleading or proof of any notice of breach of warranty.

E.

**There Is No Duty on the Part of a Retailer to Inspect or  
Make Tests on Goods He Sells.**

Appellants have casually argued that there was a duty upon the part of Aeroil to inspect and make tests on the conveyor and that they are liable because of their failure so to do. This is not the law in California. The case of *Sears Roebuck v. Marhenko*, 121 F. 2d 598 is a case wherein a hot water bottle which was not manufactured by Sears was sold by them and where a test by Sears would have revealed a defect. A judgment in the lower court was given for plaintiff, but the United States Court of Appeals reversed the judgment on the ground that there is no obligation on the part of a retailer to test or inspect any goods which it sells. This case is directly in point and is a decision of the 9th District of the Federal Court. It is based on the California decision of *Tourte v. Horton Manufacturing Co.*, 108 Cal. App. 22. This is a case in which a washing machine was alleged to be defective and suit was filed against the dealer and a nonsuit was granted and upheld. At page 23 of this decision the court stated:

“The dealer who purchases and sells an article in common and general use in the usual course of trade and business, without knowledge of its dangerous qualities, is not under a duty to exercise ordinary care to discover whether it is dangerous or not. In 45 Corpus Juris, 893, we find the same rule stated: A dealer is under no duty or obligation to examine the articles which he sells to ascertain whether there are defects therein, and . . . is not liable for an injury arising from such defects where he had no actual knowledge thereof.”

There are many other cases holding that there is no liability against a retailer unless there is a latent defect which is known to the retailer and not known to the purchaser. Among these are *Lewis v. Terry*, 111 Cal. 39 (*supra*), *Gutelius v. General Electric*, 37 Cal. App. 2d 455, *Youtz v. Thompson Tire*, 46 Cal. App. 2d 672, in which decision at page 675 appears this statement:

“(2a) The controlling factor is therefore the extent of liability of a manufacturer or repairman for defects in workmanship when the defect is known to the purchaser or third person and not known to the manufacturer.”

Appellees respectfully urge that the appellants have completely failed in their Argument I to establish any express or implied warranties flowing from the defendant Aeroil or Yundt to the decedent Herbert Weldon Young. There were no warranties at all alleged which were not true. There was no privity of contract. There was no notice of any breach and there were no latent defects known to the seller. Various cases cited by appellants might tend to establish certain warranties against manufacturers based on advertising, but the manufacturer is not involved in this action. However, here the buyer, Mr. Weigart, specifically relied on his own knowledge and experience. All of the decisions cited by the appellant in this regard apply strictly and only to the manufacturer and not to the dealer. The reasoning on which those cases are based likewise apply only to the manufacturer and not to the dealer.

IV.

**The Court Did Not Err in Not Awarding Damages to the Plaintiffs in the Sum Prayed for in the Complaint.**

Plaintiffs' second point does not require answer here. Obviously if the plaintiffs are not entitled to recover there is no right to any specific amount of damages and no finding in that regard was necessary or would have been proper. While the appellees do not agree at all with appellants as to the valuation of the case there is no need to argue this proposition here and no further argument will be made.

V.

**The Findings of the Trial Court Are Supported by the Evidence.**

It is difficult to reply to Point III of Appellants' Opening Brief in a logical or orderly fashion since this argument in appellants' brief consists of isolated statements apparently drawn at random from the transcript in order to argue that there was some evidence which might have supported findings contrary to those of the trial court. Appellants have made no effort to state all of the evidence on the points in question. Appellees have, therefore, followed the same order and referred this court to some of the contrary law and evidence on these points.

Weigart did not rely on the express warranties in the brochures. He wished to buy a Mulkey Conveyor because he knew them, knew how they were made and how they worked and how they compared with other types of conveyors he had used and with which he was familiar. [Rep. Tr. p. 142, line 23, to p. 143, line 24.] Representations in advertisements are not a part of the con-

tract of sale unless the buyer relies on those statements. (*Burr v. Sherwin Williams*, 42 Cal. 2d 682 at 696.) The Brochures do not constitute warranties to Herbert Young. There was no privity of contract between Young and respondents. (*Collum v. Pope & Talbot*, 135 Cal. App. 2d 653.) Moreover, there was no reliance on the part of the deceased. None of the brochures, except Exhibit 6, were admitted as against the defendant Aeroil. There were no express warranties made by Aeroil. Weigart had no conversations with Yundt as to the qualities of the Mulkey conveyor. He bought a Mulkey Conveyor in reliance on his own knowledge and experience. [Rep. Tr. p. 142, line 23, to p. 143, line 24.] The conveyor at the time of its delivery was of merchantable quality. The only defect claimed in design or construction was that if it were negligently tipped over then it would collapse. The conveyor had been mishandled and abused by Weigart and his employees from the date it had been purchased. Extensive changes and alterations which altered its balance and center of gravity had been made.

Aeroil Products Company was not the manufacturer and had no duty to test the conveyor for defects in its design or construction. (*Sears Roebuck v. Marhenko*, 121 F. 2d 598.) Aeroil made no representations except to copy, word for word, some of the statements made by Mulkey in their brochure. As has been stated above, Weigart did not rely on these statements. The statement that the representations in the brochures were not true has been treated above in Argument III, Subdivision C.

There was ample evidence to support the finding of the court "that the presence of said undercarriage or riser and lowering of the hitch created a hazard of over-



balancing said conveyor when lifting the hitch end of said conveyor high enough to cause said conveyor to be moved." This has been previously argued and referred to in the latter part of Argument III, Subdivision A of this brief.

While it is true that the changing of the normally lower end to the upper end did not directly injure Mr. Young, it is also equally true that even under the theory of the appellants unless Young had negligently permitted the conveyor to turn over and to hit the pavement violently it would have been impossible for the undercarriage to collapse. Therefore the alteration of the conveyor and the negligence of Mr. Young were directly responsible for the accident which caused his death.

Finally, there is ample evidence to support the finding of the trial court that Herbert Weldon Young was negligent. He did not follow the instructions of Weigart that the conveyor was not to be moved except when it was lowered. [Rep. Tr. p. 136, line 22, to p. 141, line 4.] He moved the conveyor when there was rock and debris in the road. [Rep. Tr. p. 65, line 19, to p. 70, line 25.] He did not follow the procedure outlined by Baker of moving the conveyor out a foot or so and then lowering it in stages, which Baker said was the method used by the employees for reasons of safety. This method would have made the accident impossible. [Rep. Tr. p. 102, line 1, to p. 105, line 9.] While Young was thoroughly familiar with the conveyor and had used it more than anyone else he negligently instructed Baker to remove the motor while the boom was up, thus changing the balance of the conveyor by 100 pounds. [Rep. Tr. p. 105, line 10, to p. 106, line 21.] He also negligently turned the conveyor by a 45 degree angle and lifted the



hitch waist-high at the same time, knowing the position of balance and that the engine had been removed. Also he then held on when the hitch end of the machine went up into the air, whereas if he had let go the accident would not have occurred. [Rep. Tr. p. 35, line 7, to p. 38, line 24.]

### Conclusion.

Appellees respectfully urge that the judgment of the trial court should be affirmed. Appellants have not complied with the rules of this court. Therefore the appeal should be dismissed. However, on the merits the findings of the court were supported by the evidence in all respects. Apparently appellants are acting under the erroneous delusion that in order to entitle them to a reversal of the judgment all they must show is that there was some evidence which would have supported a finding in their favor. On the contrary here the situation is reversed. The judgment of the court must stand if there is any evidence to support the court's findings on any issue that would justify a judgment in favor of the defendants. Appellees contend that there was ample testimony to support the findings of the court. First, that there was no warranty on the sale in question because of the fact that Weigart did not rely on any representations and because of the further fact that the conveyer was mistreated, altered and damaged in such a way as to terminate any warranty if there had been one. Second, that the plaintiffs failed to prove that there was any privity of contract between the deceased and these defendants and, third, further failed to prove that there was any breach of any of the statements appearing in the brochures. Fourth, that plaintiffs failed to plead or prove that there

was any notice of breach of warranty to the defendant Aeroil within a reasonable time after the occurrence of the accident; fifth, that there was any duty on the part of Aeroil to inspect the conveyor. Lastly, appellees contend that a proximate cause of the accident which resulted in the death of Herbert Young was his own negligence in the operation of the conveyor at the time of the accident.

Appellees respectfully urge that the judgment of the court below be affirmed.

EUGENE S. IVES,

*Attorney for Appellees.*

No. 15363

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

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MILDRED MARIE YOUNG, individually and DANNY LEE YOUNG, DAVID RAY YOUNG and DANIEL RAY YOUNG, through their guardian *ad litem*, Mildred Marie Young,

*Appellants,*

*vs.*

AEROIL PRODUCTS COMPANY, INC., a corporation, STRUCTURAL MATERIAL COMPANY, a corporation and DERYL S. YUNDT,

*Appellees.*

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Appeal From the United States District Court for the Southern District of California, Central Division.

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## APPELLANTS' REPLY BRIEF.

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FILED

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PAUL P. O'BRIEN, CL



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Appeal From the United States District Court for the Southern District of California, Central Division.

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**APPELLANTS' REPLY BRIEF.**

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**I.**

**The Appellants' Brief Does Comply With Rule 18, 2(d).**

The appellees quote from the case of *Thys Company v. Anglo California Bank*, 219 F. 2d 131, at page 132; however, the quotation is not complete. The quotation is proceeded by the following sentence:

“Here, appellants' first specification of error as to five findings of fact, four conclusions of law, and two distinct questions relating to the admissibility of evidence.”

Therefore, the *Thys Company* case is not in point. Appellants in the present appeal have set forth each error separately. If there is no evidence to support a finding, there is no way but to state the negative. If one states there is no evidence to support a finding, then all the evidence must be looked at and if it isn't there the negative is proved. Surely the court intends in the rule for the negative to be merely stated. It seems inconceivable that with each error the court wants all the evidence and then a statement there is no evidence to support the quoted finding.

## II.

### **The Judgment Should Be Reversed Because the Evidence Does Not Support the Findings.**

The appellees' brief states on page 24 last sentence as follows:

"When Weigart purchased the conveyor he relied on the statements as to how it was to be used and that one of his employees could handle and operate the machine and he relied on the advertising matter that he showed his employees. He (Weigart) remembers bringing the conveyor to the job. He had brochures, Exhibits 1 to 6, he showed them to Herbert Young. He went over them with all the employees. Weigart was not present at the time of the accident. He was told about it and went to the scene. Sometime that day he remembers a phone call to Deryl S. Yundt. He told Yundt that the machine had collapsed and killed one of his employees and that he would like to have him come to the scene to see the machine. Yundt stated that he knew what happened and there was no need of coming out."

The court admitted this evidence. The objection of the defendants was overruled. [Tr. Vol. II, p. 135, lines 15-19.] There was no denial of this by defendants.

Then, at page 10 the appellees state:

“Young had been handling the machine the way that they customarily handled it. When he (Thomas) saw Young move the conveyor he would usually turn it parallel to the street and then lower the boom to move the conveyor to another location. He had seen Herbert Young move the conveyor in the same way before but never saw him carried up into the air.”

At page 13,

“He (Thomas) had operated the conveyor and relied on the statements he had seen in the advertising as to how to operate the conveyor. The only instructions that Thomas had had as to operating the machine were in the brochures.”

There is nothing in the evidence that appellants can find about the “riser” being thirty inches in height. The evidence is that it was 18 inches.

On page 17, the appellees state “Aeroil handed them out (the brochures) without making any investigation.”

On page 27, the appellees state: “When Weigart was working for Bennett he first saw copies of the brochures which are Exhibits 1 to 6.”

The trial court admitted into evidence the brochures marked Exhibits 1 to 6, inclusive. [Tr. Vol. II, p. 8, lines 21-23.]

The appellants prepared a narrative statement of the evidence and endeavored to have it made a part of the record on appeal. This was to save cost and aid the

court. The defendants objected to a narrative statement and insisted on the whole transcript which was furnished.

The appellees have not referred to the transcript to point out where the testimony is that supports any of the questioned findings. If there is testimony to support a finding it can be pointed out. They instead wrote a long statement of the evidence which does not support the findings.

The appellees, on page 31 of their brief, state:

“In his (Dr. Wood’s) opinion, if the 18 inch plate had not been on the normally lower end there would have been some slight but in his opinion insignificant changes. The energy generated by the machine tipping over would be less but still more than needed to cause the machine to collapse. If the rollers were constricted this type of collapse could not occur.”

### III.

#### **Answer to Appellees’ Point III.**

In answer to Point III of the appellees’ argument, appellants wish to state the following:

In the case of *Collum v. Pope & Talbot*, 135 Cal. App. 2d 653, 288 P. 2d 75, the court stated:

“More fundamental, however, and pivotally significant, is the fact that the cutting of logs into boards of varying sizes is not ‘manufacturing’ within the meaning of that word, or its variants, as used by Supreme Court when in the Burr Case it noted the two exceptions to the requirement of privity of contract.”

The definition referred to is stated by the court as follows:

“Each has to do with a product which has been put together, manufactured, assembled, fabricated, and marketed in such a fashion that it does not admit of ready inspection and contains deleterious or defective ingredients which render it unfit for the use for which it is expressly or impliedly warranted.”

Then the court refers to *Bahlman v. Hudson Motor Car Co.* (1939), 290 Mich. 683, 288 N. W. 309, in which the literature represented the auto had a seamless steel roof. Also, the case of *Baxter v. Ford Motor Co.* (1932), 168 Wash. 456, 12 P. 2d 409, 88 A. L. R. 521, which was an express representation that the windshield of a car was shatterproof glass. The court quotes from *Escola v. Coca-Cola Bottling Co.*, 24 Cal. 2d 453, 467-468, 15 P. 2d 436, 443.

The court then stated:

“He (the mill operator) merely took sections of a tree, a product of nature, and cut them to size.”

This case is not in point because the portable elevator is a manufactured product. It is put together by man and designed by man. It is not a product of nature. The defective ingredient in the conveyor was that the articulate member of the undercarriage was not constrained against motion toward the normally lower end of the machine except by the weight of the conveyor or “boom” and this defect rendered it unfit for the use for which it was expressly warranted (*i. e.*, to be handled and operated by one man and easily maneuvered). This defect was not apparent by inspection of the machine.

The case of *Ivancovich v. Bertossi*, 202 Cal. 770, 202 Pac. 748, cited by appellees is not in point. One witness testified that the mixing of the white or muscat wine with zinfandel wine would spoil the mixture. The evidence on this point is quoted.

In the present set of facts, the evidence is that the “riser” or 18 inch plate on the normally lower end made no significant difference. Dr. Wood testified,

“Therefore, since the energy available is considerably larger than the energy required, again it is my opinion that the collapse would occur in that case in essentially the same manner.” [Tr. Vol. II, p. 196, lines 21-24.]

The appellees own statement of the evidence on page 29 states that Mr. Lowell E. Annan testified,

“When he had completed the December, 1953 job, after the conveyor was turned over, from his many years of experience in doing that type of work and from looking at the conveyor he could tell it was in its former condition.” [Tr. Vol. II, p. 162, lines 19-24; p. 159, lines 5-8.]

All of the evidence is that the defect in the conveyor was present at the time of its delivery to Weigart and was not affected by the 18 inch plates or “riser” or by the repairs in welding or by its tipping over sidewise and being repaired to its former condition. The defect was inherent in the machine at the time it was assembled and marketed by Aeroil and continued as a constant hazard to any laborer who used the machine. Aeroil assembled, marketed and made advertising statements about the machine to induce its sale and use without any tests at all to see if the machine was safe to be used by laborers



or if the statements about the machine were true. This conveyor was a death trap and should never have been put on the market.

The appellees rely heavily on the case of *Vogel v. Thrifty Drug Co.*, 43 Cal. 2d 184, 272 P. 2d 1. We do not believe this case is in point. In the *Vogel* case the plaintiff was the buyer. Civil Code, Section 1769, reads in part:

“But, if, after acceptance of the goods, the *buyer* fails to give notice to the seller of the breach of any promise or warranty within a reasonable time after the *buyer* knows, or ought to know of such breach, the seller shall not be liable therefor.”

In the present appeal, the plaintiff, Mildred Marie Young, and her children are not the “buyer”. There is no buyer-seller relationship between the plaintiffs and the defendants.

The difficulty in this case has been to endeavor to understand what the California Supreme Court has established in the case of *Burr v. Sherwin-Williams Co.*, 42 Cal. 2d 682, 68 P. 2d 1041, and *Kalash v. Los Angeles Ladder Co.*, 1 Cal. 2d 229, 34 P. 2d 481; *Lane v. C. A. Swanson & Sons*, 130 Cal. App. 2d 210, 278 P. 2d 723; *Escola v. Coca-Cola Bottling Co. of Fresno*, 24 Cal. 2d 453, 15 P. 2d 436; *Sherward v. Virtue*, 20 Cal. 2d 410, 126 P. 2d 345; *Free v. Sluss*, 87 Cal. App. 2d (Supp.) 933, 197 P. 2d 854.

As discussed above, the article must be manufactured. It must not be a product of nature. This is obviously so that there is human control over its design and construction. Its safety can be controlled. The next element is that the manufactured product must be defective so

as to place life or limb in peril. Then there must be some wrong by the defendants. The wrong takes various forms. In the *Escola* case it was the failure of the person who filled the bottle with Coca-Cola to test the bottle for defects. In the *Swanson & Sons* case it was advertising the chicken as "boned" when it was not. In the *Burr* case, it was putting weed killer in the spray and not stating this on the label listing the active ingredients. In the *Kalash* case it was not inspecting the rung on the ladder that broke. In *Free v. Sluss*, it was the words "Guarantee of quality" printed on the soap when the soap was not good.

Then in this type of case, the court has held in *Gosling v. Nichols*, 59 Cal. App. 2d 442, 139 P. 2d 86, that it is a wrong or a tort.

The court rules out privity of contract because the wrong is the actionable element.

In the present case the wrong is that the defendant, Aeroil, printed and distributed the brochures which were not true without any tests or investigation as to their truth and thereby causing reliance thereon and the resulting death of Herbert Weldon Young.

This is not a buyer-seller warranty case. The cause of action as pointed out has been held by the California court to be a tort and the tort rules apply.

There was no buyer-seller relationship in the *Escola* case. The plaintiff was a waitress in a restaurant. The bottle of Coca-Cola was delivered and sold to her employer. In the *Kalash* ladder case the employee was the plaintiff. In the *Burr* case, the owner of the cotton field was not the purchaser of the insecticide. In none of these

cases is notice required as it is when the action is between buyer and seller.

The appellees also rely heavily on *Tourte v. Horton Manufacturing Co.*, 108 Cal. App. 22, 200 Pac. 919. This case is no longer California law. The recent *Temeroli v. Austin Trailer Equipment Co.*, 102 Cal. App. 2d 464, 227 P. 2d 923, at 931, states the following:

“It is next apparently urged that, in the absence of knowledge on the part of the seller of a latent defect, the seller, who is not the manufacturer, is not liable for damage caused by latent defect. In this connection *Tourte v. Horton Mfg. Co.* is cited. That case undoubtedly held that a seller who was not a manufacturer was not liable for a latent defect, at least where the buyer had knowledge of the defect. That case was decided under the law as it existed prior to the adoption of the Uniform Sales Act in this state. While there are a few cases that hold that it was not the intention of the Sales Act to make a seller who is not the manufacturer liable for damages caused by a latent defect, the substantial weight of authority is to the effect that under the Uniform Sales Act, the implied warranty extends to latent defects. This appeals to us as sound law.”

The case of *Sears Roebuck v. Marhenko*, 121 F. 2d 598, was decided before the *Temeroli* case and therefore relied on the *Tourte v. Horton Manufacturing Co.* case. Therefore, when the case of *Tourte v. Horton Manufacturing Co.* fell, also the *Sears Roebuck v. Marhenko* case must fall because it was standing upon the *Tourte* case.

Mr. Baker testified [Tr. Vol. II, p. 112, lines 17-24] as follows:

“Q. Did you ever hear any orders from anyone as to how it was to be moved? A. No, sir. Every time I seen it moved, it was about the same procedure and I just took it for granted that that was it; I don’t know anything about it.

Q. Was that the way you saw it moved every time Herbert Young moved it? A. Yes, sir.

Q. And as I understood, he was in charge of that conveyor when he was working on it ordinarily. A. Yes, sir.”

Then on page 102, Tr. Vol. II, line 25, and page 103, lines 1 and 2:

“Q. When you moved the conveyor from place to place, did you leave the motor on? A. No sir, we had to take it off.”

Mr. Weigart testified, page 140, Tr. Vol. II, lines 4-16:

“Q. Now, with reference to this particular piece of equipment, what instructions did you give as to how it was to be moved? A. I went over the brochures with the employees and showed them each item and told them how to raise it and how to lower it and how to put it in position, to the best of my knowledge from the brochures.

Q. You told them, with reference to how to lower it, that it should be pulled away from the building and lowered before it was moved, is that right? A. It would have to be pulled away from the building before lowering it.

Q. Then you said to pull it away and lower it? A. You would have to move it before you lowered it.”

Mr. Thomas testified at page 42, Vol. II, line 7, to page 43, line 2:

“Q. Wasn’t there some rock that had been spilt on the street then? A. Yes.

Q. Did you see it afterwards? A. Yes, there was some rock spilt there, yes.

Q. With reference to the wheels, did you notice whether either of the wheels of the elevator struck any of that rock? A. No, they didn’t.

Q. The wheels were swung a matter of a 45 degree turn before the time that the top of the elevator went down? A. Yes.

Q. And had you seen Mr. Young move this elevator before? A. Yes.

Q. And in doing that, the handler always swings it around so it was parallel with the street, before moving it to the next place? A. No, not always. If there were any obstructions you would have to swing it that way; like in that particular case, he had to swing it far enough to clear to move it.”

Then, at page 44, lines 8 to 15:

“Q. Now, on this particular occasion, you say you saw Mr. Young moved up into the air on the elevator? A. Yes.

Q. Had you ever seen that occur before? A. No, sir.

Q. And had you seen Mr. Young move this elevator in the same way before? A. Yes.”

Then Mr. Weigart testified at page 135, Vol. II, lines 4 to 24:

“Q. Now, after you got there, do you remember making a telephone call to Mr. Yundt on the telephone, is that right? A. Yes, sir.

Q. Now, would you tell us what the conversation was? What did you say and what did Mr. Yundt say?

Mr. Ives: To which, if your Honor please, I object as to all the defendants I represent except Mr. Yundt himself, on the ground that it is not binding on them.

The Court: The objection is overruled. It will not be binding on any of the defendants if they are not coupled up with Mr. Yundt.

The Witness: Should I answer the question, sir?

The Court: Yes.

A. I called Mr. Yundt and told him that the machine had collapsed and killed one of my employees and that I would like for him to come to the scene of the accident, to see the machine. As I recall, he stated that he knew what happened and there wasn't any need coming out."

Mr. Yundt testified at page 82, Vol. II, line 10, to page 83, line 2:

"Q. You do remember that Mr. Weigart did call?

A. I do remember he called me, but what day it was I don't know.

Q. And he told you that there had been an accident? A. That is right.

Q. And you do not remember what was said in the conversation? A. I do not remember.

Q. You don't remember what you said? A. I believe I told him I could not get out on that particular morning to the place where the conveyor was resting at that time, and I did not go out due to the fact I was no longer employed by Aeroil Products Company. The sale was made through that company.



Q. Now, you were selling that machine were you not, at that time? A. That is correct, yes, sir. I advised the manufacturer that date of the accident."

It should be noticed Mr. Yundt did not deny that he stated to Mr. Weigart "that he knew what happened and there wasn't any need coming out." Therefore, this would indicate that defendants knew of the inherent defect in the machine. The knowledge of the defect by the defendants was within them and after such evidence as this it surely is probative that nowhere did the defendants testify they did not know of the defect and the danger of the collapse of the undercarriage of the machine.

Mr. Thomas testified at page 52, Tr. Vol. II, lines 14 to 20:

"Q. Did you notice anything in relation to how that the machine needed to be moved in order to lower it and clear the bank? A. Well, there would be one of the two methods. Like Mr. Young done it, or run diagonally across the street with it so it could be clear across the street and block the street, to be lowered completely down."

Then, at page 53, Tr. Vol. II, line 16, to page 54, line 6:

"Q. (Mr. Thomas): Did you operate that machine yourself there? A. Yes.

Q. In operating that machine did you rely on the statements that you read in this advertising material that you have looked at, as to how to operate the machine? A. Yes.

Mr. Ives: I object to that on the grounds it is immaterial.

The Court: Overruled.

The Reporter: You said 'Yes'?

The Witness: Yes.

Q. By Mr. Rickett: There were no other instructions that you had with relation to the operation of that machine, except those that were contained in those brochures, isn't that right. A. Yes, that is all we had and all we relied on."

Respectfully submitted,

ARLO E. RICKETT, JR.,

*Attorney for Appellants.*

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In the  
United States  
Court of Appeals  
For the Ninth Circuit

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CHARLES LAMBERT, *Appellant,*

v.

MERLE E. SCHNECKLOTH, Superintendent of Washington State Penitentiary, at Walla Walla, Washington,  
*Appellee.*

} No. 15364

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APPEAL FROM THE JUDGMENT OF THE DISTRICT COURT OF THE UNITED STATES FOR THE EASTERN DISTRICT OF WASHINGTON, SOUTHERN DIVISION

HONORABLE SAMUEL M. DRIVER, JUDGE

---

BRIEF OF APPELLEE

---

JOHN J. O'CONNELL,  
*Attorney General,*

MICHAEL R. ALFIERI,  
*Assistant Attorney General,*

*Attorneys for Appellee.*

Temple of Justice, Olympia, Wash., 914 Puget Sound Bank Bldg.,  
Tacoma 2, Wash.

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In the  
United States  
Court of Appeals  
For the Ninth Circuit

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CHARLES LAMBERT,	<i>Appellant,</i>	} No. 15364
v.		
MERLE E. SCHNECKLOTH, Superintendent of Washington State Penitentiary, at Walla Walla, Washington,	<i>Appellee.</i>	

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APPEAL FROM THE JUDGMENT OF THE DISTRICT COURT OF THE UNITED STATES  
FOR THE EASTERN DISTRICT OF  
WASHINGTON, SOUTHERN  
DIVISION

HONORABLE SAMUEL M. DRIVER, JUDGE

---

BRIEF OF APPELLEE

---

JOHN J. O'CONNELL,  
*Attorney General,*

MICHAEL R. ALFIERI,  
*Assistant Attorney General,*

*Attorneys for Appellee.*

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In the  
United States  
Court of Appeals  
For the Ninth Circuit

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CHARLES LAMBERT,	<i>Appellant,</i>	} No. 15364
v.		
MERLE E. SCHNECKLOTH, Superintendent of Washington State Penitentiary, at Walla Walla, Washington,	<i>Appellee.</i>	

---

APPEAL FROM THE JUDGMENT OF THE DISTRICT COURT OF THE UNITED STATES  
FOR THE EASTERN DISTRICT OF  
WASHINGTON, SOUTHERN  
DIVISION

HONORABLE SAMUEL M. DRIVER, JUDGE

---

BRIEF OF APPELLEE

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APPELLEE'S STATEMENT OF THE CASE

This individual pleaded guilty to the crime of robbery on October 18, 1950, and was sentenced to twenty years confinement in the Washington State Penitentiary. While in prison, he was charged with first degree murder of a fellow inmate. On arraignment he entered a not guilty plea and two attorneys were appointed for him. Subsequently, he pleaded

guilty to first degree assault and was sentenced to fifty years confinement. This judgment was entered on June 22, 1955. It is this latter judgment and sentence which was attacked in the lower court and which the trial court summarily denied without requiring a return and answer from the appellee. We believe that the action of the trial court was correct. However, if a return and answer had been required, the appellee would have been able to have supplied a record to show that the issues which the appellant now complains of which were not heard by the trial court had been previously heard by a trial court of the State of Washington. The trial court of the State of Washington heard testimony from this appellant, from the prosecuting attorney, and from the attorney of the appellant, and made findings of fact and conclusions of law that no constitutional rights of this appellant have been violated.

#### APPELLEE'S STATEMENT OF THE QUESTION INVOLVED

Did the lower court properly deny the petition for a writ of habeas corpus, which attacked the consecutive sentence which had not yet begun to run, without contesting the validity of the judgment and sentence pursuant to which he is presently incarcerated.

## ARGUMENT

It is respectfully contended by the appellee that the case of *McNally v. Hill*, 293 U. S. 131, 79 L. ed. 238, 243-244, conclusively substantiates the lower court's action in dismissing the application for a writ as being premature. The following quotes from the opinion and footnote will demonstrate the precedent which has guided the United States Supreme Court and the courts of appeal in such like matters:

“Considerations which have led this Court to hold that *habeas corpus* may not be used as a writ of error to correct an erroneous judgment of conviction of crime, but may be resorted to only where the judgment is void because the court was without jurisdiction to render it, *Ex parte Watkins*, *supra* (3 Pet. 203, 7 L. ed. 653); *Knewel v. Egan*, 268 U. S. 442, 445, 447, 69 L. ed. 1036, 1039, 1040, 45 S. Ct. 522, lead to the like conclusion where the prisoner is lawfully detained under a sentence which is invalid in part. *Habeas corpus* may not be used to modify or revise the judgment of conviction. *Harlan v. McGourin*, 218 U. S. 442, 54 L. ed. 1101, 31 S. Ct. 44, 21 Ann. Cas. 849; *United States v. Pridgeon*, 153 U. S. 48, 63, 38 L. ed. 631, 637, 14 S. Ct. 746. Even when void, its operation may be stayed by *habeas corpus* only through the exercise of the authority of the court to remove the prisoner from custody. That authority cannot be exercised where the custody is lawful.

“Wherever the issue has been presented, this Court has consistently refused to review,

upon *habeas corpus*, questions which do not concern the lawfulness of the detention. *Re Graham*, 138 U. S. 462, 34 L. ed. 1051, 11 S. Ct. 363; *Re Swan*, 150 U. S. 637, 653, 37 L. ed. 1207, 1211, 14 S. Ct. 225; *Harlan v. McGourin*, 218 U. S. 442, 54 L. ed. 1101, 31 St. Ct. 44, 21 Ann. Cas. 849, *supra*; *United States v. Pridgeon*, 153 U. S. 48, 38 L. ed. 631, 14 S. Ct. 746, *supra*; *Nishimura Ekiu v. United States*, 142 U. S. 651, 35 L. ed. 1146, 12 S. Ct. 336; *Iasigi v. Van de Carr*, 166 U. S. 391, 41 L. ed. 1045, 17 S. Ct. 595; *Hale v. Henkel*, 201 U. S. 43, 77, 50 L. ed. 652, 666, 26 S. Ct. 370; *Ex parte Wilson*, 114 U. S. 417, 421, 29 L. ed. 89, 90, 5 S. Ct. 935. The lower federal courts have generally denied petitions for the writ where the prisoner was at the time serving a part of his sentence not assailed as invalid."

Footnote # 6:

"The Courts of Appeals in circuits other than the 8th have uniformly denied petitions for writs of *habeas corpus* when the prisoner was not at that time serving the part of the sentence said to be invalid. *Carter v. Snook*, 28 F. (2d) 609 (C. C. A. 5th); *Eori v. Aderhold*, 53 F. (2d) 840, 841 (C. C. A. 5th); *De Bara v. United States*, 99 F. 942 (C. C. A. 6th); *United States v. Carpenter*, 151 F. 214 (C. C. A. 9th), 9 L. R. A. (N.S.) 1043, 10 Ann. Cas. 509; *Mabry v. Beaumont*, 290 F. 205, 206 (C. C. A. 9th); *Dodd v. Peak*, 60 App. D. C. 68, 47 F. (2d) 430, 431. And to the like effect, see *Woodward v. Bridges*, 144 Fed. 156 (D.C.); *Ex parte Davis*, 112 F. 139 (C.C.)."

## CONCLUSION

It is respectfully submitted that precedent and logic substantiate the actions of the lower court in dismissing this action as premature and that therefore this appeal should be dismissed.

Respectfully submitted,

JOHN J. O'CONNELL,  
*Attorney General,*

MICHAEL R. ALFIERI,  
*Assistant Attorney General,*  
*Attorneys for Appellee.*





No. 15370

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United States  
Court of Appeals  
for the Ninth Circuit

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COMMISSIONER OF INTERNAL REVENUE,  
Petitioner,

VS.

MULTNOMAH OPERATING COMPANY,  
Respondent.

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Transcript of Record

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Petition to Review a Decision of the Tax Court  
of the United States

FILED

MAR - 6 1957

PAUL P. O'BRIEN, CLERK



No. 15370

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United States  
Court of Appeals  
for the Ninth Circuit

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COMMISSIONER OF INTERNAL REVENUE,  
Petitioner,

vs.

MULTNOMAH OPERATING COMPANY,  
Respondent.

---

Transcript of Record

---

Petition to Review a Decision of the Tax Court  
of the United States



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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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## APPEARANCES

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Seattle 4, Washington,  
For the Respondent.



The Tax Court of the United States

Docket No. 52071

MULTNOMAH OPERATING CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1954

Mar. 3—Petition received and filed. Taxpayer notified. Fee paid.

Mar. 4—Copy of petition served on General Counsel.

Mar. 29—Answer filed by General Counsel.

Mar. 29—Request for hearing in Seattle, Washington, filed by General Counsel.

Mar. 31—Notice issued placing proceeding on Seattle, Washington, calendar. Service of answer and request made.

1955

Mar. 14—Hearing set June 13, 1955, Seattle, Washington.

June 17—Hearing had before Judge Withey, on merits. Record held open 30 days to receive stipulation of facts. Briefs 9/15/55. Replies 10/17/55.

July 1—Transcript of hearing 6/17/55 filed.

July 7—Appearance of Harry Henke, Jr., as counsel filed.

Aug. 19—Stipulation of facts filed.

Aug. 19—Supplemental stipulation of facts filed.

Sept. 14—Brief filed by taxpayer. Copy served  
9/16/55.

Sept. 15—Brief filed by General Counsel. Copy  
served 9/16/55.

Oct. 12—Motion for extension to October 29, 1955,  
to file reply brief, filed by taxpayer.  
10/12/55 granted.

Oct. 27—Reply brief filed by taxpayer. Copy served.

1956

Feb. 23—Memorandum findings of fact and opinion  
filed, Withey, J. Decision will be entered  
under Rule 50. Copy served 3/2/56.

Mar. 21—Motion to vacate and review opinion by  
full court, filed by respondent. 3/22/56  
denied.

Mar. 21—Amendment to motion to vacate and re-  
view opinion by full court, filed by re-  
spondent. 3/22/56 denied.

June 12—Agreed computation for entry of decision,  
filed.

June 13—Decision entered, Judge Withey, Divi-  
sion 4.

Sept. 5—Petition for review by United States  
Court of Appeals, Ninth Circuit, filed by  
respondent.

Sept. 24—Proof of service filed (petitioner).

Sept. 24—Proof of service filed (Harry Henke, Jr.,  
counsel).

- Oct. 4—Motion for extension of time for filing record on review and docketing petition for review to Dec. 4, 1956, filed by respondent.
- Oct. 5—Order extending time for filing record on review and docketing petition for review to 12/4/56, entered. Served 10/8/56.
- Nov. 14—Statement of points with proof of service thereon, filed.
- Nov. 14—Designation of contents of record on review, with proof of service thereon, filed.
- Nov. 14—Supplemental designation of contents of record on review, with proof of service thereon, filed.

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The Tax Court of the United States

Docket No. 52071

MULTNOMAH OPERATING CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency Ap:AA:90D:HOS:EEH, dated De-

cember 15, 1953, and as a basis of its proceeding alleges as follows:

1. The petitioner is a corporation, with its principal office at 7th and Pike Streets, c/o Waldorf Hotel, Seattle, Washington. The returns for the periods here involved were filed with the Collector for the District of Washington.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on December 15, 1953.

3. The taxes in controversy are income taxes for the calendar years 1948 and 1949, in the amounts shown below:

Income Taxes			
Year	Proposed Liability	Assessed	Deficiency
1948.....	\$113,581.31	\$101,775.88	\$11,805.43
1949.....	117,245.12	105,714.56	11,530.56
	<hr/>	<hr/>	<hr/>
Totals.....	\$230,826.43	\$207,490.44	\$23,335.99

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

#### Year 1948

(a) The Commissioner of Internal Revenue erred in failure to allow a deduction in the amount of \$30,000.00 for rent paid. The deficiency notice states that the amount of \$30,000.00 was paid to stockholders and has been disallowed as a deduction.



Year 1949

(Same as for year 1948 above)

5. The facts upon which the taxpayer relies as basis of its appeal are as follows:

(a) The Commissioner of Internal Revenue erred in failing to allow for the year 1948 and the year 1949 the amount of \$30,000.00 which was paid during each year as rental under an agreement which originally was entered into in the year 1930, and has been allowed as rental during all subsequent years. That the amount of \$30,000.00 is not paid to stockholders in proportion to their stock holdings and is clearly for rental. An agreement was entered into when assignment of the original lease was made with the Multnomah Operating Co. and has remained in effect.

Wherefore, the petitioner prays that this Honorable Court may hear and determine its appeal.

/s/ HAROLD L. SCOTT,  
Counsel.

Duly Verified.

## EXHIBIT A

U. S. Treasury Department  
Office of the District Commissioner  
Internal Revenue Service  
123 U. S. Court House Bldg.  
Seattle 4, Washington

December 15, 1953.

In replying refer to:

Ap:AA:90D:HOS:EEH

Multnomah Operating Co.,  
c/o Waldorf Hotel,  
7th and Pike Street,  
Seattle, Washington.

Gentlemen:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1948, and 1949, discloses a deficiency of \$23,335.99 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with the Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Colum-

bia, in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Assistant Regional Commissioner, Appellate, 123 United States Court House, Seattle 4, Washington. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours,

T. COLEMAN ANDREWS,  
Commissioner of Internal  
Revenue.

Enclosures:

Statement

Form 1276

Agreement Form

Ap :AA :90D :HOS :EEH

## EXHIBIT A

(Copy)

## Statement

Multnomah Operating Co.  
c/o Waldorf Hotel  
7th and Pike Street  
Seattle, Washington

Income Tax Liability for the Taxable Years Ended  
December 31, 1948 and December 31, 1949

Year	Liability	Assessed	Deficiency
1948 .....	\$113,581.31	\$101,775.88	\$11,805.43
1949 .....	117,245.12	105,714.56	11,530.56
Totals .....	\$230,826.43	\$207,490.44	\$23,335.99

In making this determination of your income tax liability, careful consideration has been given to the reports of examination dated July 12, 1951; to your protest dated October 29, 1951; and to the statements made at the conferences held on February 6, 1952 and December 1, 1953.

A copy of this letter and statement has been mailed to your representative, Mr. Harold L. Scott, Dexter Horton Building, Seattle, Washington, in accordance with the authority contained in the power of attorney executed by you.

## Taxable Year Ended December 31, 1948

## Adjustments to Net Income

Net income as disclosed by return, Form 1120 .....	\$267,938.63
Unallowable deductions and additional income: (a) Rental deductions.....	31,066.90
Net income as adjusted.....	\$299,005.53

Explanation of Adjustment

(a)	(1)	Payments to stockholders.....	\$30,000.00
	(2)	Property taxes overstated.....	1,066.90

---

Total adjustment .....\$31,066.90

(1) It is held that you are not entitled to deduct the sum of \$30,000.00 as ordinary and necessary expense of your business under section 23(a)(1)(A) of the Internal Revenue Code, which amount was paid to your stockholders and claimed as rental expense on your return.

(2) The rental deduction claimed on your return is reduced \$1,066.90, representing the overstatement of property taxes accrued by you on leased property, and claimed on the return as a deduction for rental expense.

Computation of Income Tax

Net income as adjusted.....	\$299,005.53
Less: Excess of net long-term capital gain over net short-term capital loss....	15.70
Ordinary net income.....	\$298,989.83
Less: Dividends received credit.....	102.00
Balance subject to normal tax and surtax	\$298,887.83
Normal Tax: 24% of \$298,887.83.....	\$ 71,733.08
Surtax: 14% of \$298,887.83.....	41,844.30
Partial tax .....	\$113,577.38
Plus: 25% of \$15.70.....	3.93
Income tax liability.....	\$113,581.31
Income tax assessed: Original Account No. 4100797 .....	101,775.88
Deficiency in income tax.....	\$ 11,805.43

## Taxable Year Ended December 31, 1949

## Adjustments to Net Income

Net income as disclosed by return, Form 1120 .....	\$278,196.19
Unallowable deductions and additional income: (a) Rental deduction.....	30,343.60
Net income as adjusted.....	<u>\$308,539.79</u>

## Explanation of Adjustment

(a) (1) Payments to stockholders.....	\$30,000.00
(2) Property taxes overstated.....	343.60

Total adjustment .....\$30,343.60

(1) It is held that you are not entitled to deduct the sum of \$30,000.00 as ordinary and necessary expense of your business under section 23(a)(1)(A) of the Internal Revenue Code, which amount was paid to your stockholders and claimed as rental expense on your return.

(2) The rental deduction claimed on your return is reduced \$343.60, representing the overstatement of property taxes accrued by you on leased property, and claimed on the return as a deduction for rental expenses.

## Computation of Income Tax

Net Income as adjusted.....	\$308,539.79
Normal-tax and surtax net income.....	\$308,539.79
Normal tax: 24% of \$308,539.79.....	\$ 74,049.55
Surtax: 14% of \$308,539.79.....	43,195.57
Income tax liability.....	<u>\$117,245.12</u>
Income tax assessed: Original, Account No. 4101083 .....	105,714.56
Deficiency in income tax.....	<u>\$ 11,530.56</u>

Received and Filed March 3, 1954, T.C.U.S.

Served March 4, 1954.



[Title of Tax Court and Cause.]

ANSWER

Comes Now the Commissioner of Internal Revenue, by his attorney, Daniel A. Taylor, Chief Counsel, Internal Revenue Service, and for answer to the petition filed herein, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits the allegations contained in paragraph 3 of the petition.

4. (a). Denies that in determining the deficiencies asserted in the statutory notice of deficiencies herein the respondent committed any error, and specifically denies the allegations of error set forth in subparagraph (a) of paragraph 4 of the petition.

5. (a). Denies the allegations contained in subparagraph (a) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation contained in the petition, not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the petitioner's appeal be denied and that the Commissioner's determination of deficiencies be approved.

/s/ DANIEL A. TAYLOR, W.H.P.  
Chief Counsel,  
Internal Revenue Service.

Filed March 29, 1954, T.C.U.S.

[Title of Tax Court and Cause.]

### STIPULATION OF FACTS

Pursuant to Permission of the Court and oral stipulation made and entered into by and between counsel for petitioner and respondent in open Court upon June 17, 1955, the following facts are hereby stipulated and entered into the record of this proceeding.

1. The total stock of petitioner outstanding at all times was 250 shares of common stock. These shares were held as follows on the following dates:

#### Multnomah Operating Co.

Shareholders July 1, 1931; January, 1944-48-49.

[This list of Shareholders is set out in full in Memorandum Findings of Fact, pages 25-39 and is not duplicated here.]

#### Multnomah Operating Co.

Members of Voting Trust from 5-1-40 to 5-1-50

(Not renewed)

[This list of Members of Voting Trust is set out in full in Memorandum Findings of Fact, pages 25-39, and is not duplicated here.]

This voting provided that the stock would be voted by S. W. Thurston, or if he should die or become incapacitated, unable or unwilling to vote said stock, said stock would be voted by F. A. Dupar,

and if they both died, became incapacitated, unable or unwilling to vote said stock, then said stock would be voted by F. M. Kenney.

2. The total outstanding stock of the Maltby-Thurston Hotels, Inc., was as shown below in the following tabulations. These shares were held as follows on the following dates:

Maltby-Thurston Hotels, Inc.

Principal Stockholders

[This list of Principal Stockholders is set out in full in Memorandum Findings of Fact, pages 25-39, and is not duplicated here.]

Stock in Voting Trust

[This list of Stock in Voting Trust is set out in full in Memorandum Findings of Fact, pages 25-39, and is not duplicated here.]

3. The total outstanding stock of the Western Hotels, Inc., was at all times as shown in the following tabulation. These shares were held as follows on the following dates:

Western Hotels, Inc.

Shareholders July 1, 1931; January, 1944-48-49

[This list of Shareholders is set out in full in Memorandum Findings of Fact, pages 25-39, and is not duplicated here.]

Capital Stock of Western Hotels, Inc., reduced from 10,000 shares to 100 shares June 20, 1934.

4. The total outstanding stock of the Pacific Coast Investment Co. was at all times 600,000 shares of common stock. These shares were held as follows on the following dates:

Pacific Coast Investment Co.

Stockholders List

July 1, 1931

[This list of Stockholders is set out in full in Memorandum Findings of Fact, pages 25-39, and is not duplicated here.]

Pacific Coast Investment Co.

Stockholders List

January 1, 1944

[This list of Stockholders is set out in full in Memorandum Findings of Fact, pages 25-39, and is not duplicated here.]

Pacific Coast Investment Co.

Stockholders List

January 1, 1948

[This list of Stockholders is set out in full in Memorandum Findings of Fact, pages 25-39, and is not duplicated here.]

Pacific Coast Investment Co.

Stockholders List

January 1, 1949

[This list of Stockholders is set out in full in Memorandum Findings of Fact, pages 25-39, and is not duplicated here.]

5. With reference to the Maltby-Thurston voting trust, the voting trustees were H. E. Maltby, S. W. Thurston, T. E. Himmelman, F. A. Dupar and F. M. Kenney. The number of shares subject to this trust held by the trustors and the beneficial owners of the stock is as set forth in Paragraph 2. Paragraphs 8-11 below set forth the information as to whether any of the beneficial owners of the stock subject to this voting trust were officers, employees or directors of either Maltby - Thurston Hotels, Inc.; Multnomah Operating Company, Western Hotels, Inc., or Pacific Coast Investment Company.

6. It is stipulated that no money or property was paid or given by Maltby-Thurston Hotels, Inc., for the lease, an extract of which has been admitted in evidence in this proceeding as Exhibit 1, except the payments required to be made by the terms of said lease as shown in said Exhibit 1.

7. It is stipulated that the rentals paid to Hauser Securities Company by Multnomah Operating Company are set forth below, with the exception of those years for which there is no information available:

Schedule of Rent Paid Hauser Securities Company  
by Multnomah Operating Company  
(Detail of rent for preceding years not available)

	Base	Percentage	Total
39 per mo. \$5,628.65.....	\$ 67,543.80	\$ 7,057.53	\$ 74,601.33
40 .....	67,543.80	7,572.99	75,116.79
41 .....	67,543.80	11,256.84	78,800.64
42 .....	67,543.80	34,602.78	102,146.58
43 .....	67,543.80	68,835.13	136,378.93



	Base	Percentage	Total
1944 per mo. 2/1/44 \$8,500. ....	\$ 99,128.65	\$ 45,806.19	\$114,934.8
1945 .....	102,000.00	50,083.99	152,083.9
1946 .....	102,000.00	66,424.03	168,424.0
1947 .....	102,000.00	97,322.87	199,322.8
1948 .....	102,000.00	115,604.53	217,604.5
1949 .....	102,000.00	122,847.57	224,847.5
1950 .....	102,000.00	132,845.74	234,845.7
1951 .....	102,000.00	152,252.54	254,252.5
1952 .....	102,000.00	178,356.00	280,356.0
1953 .....	102,000.00	209,245.71	311,245.7
1954 .....	102,000.00	212,974.43	314,974.4

8. The officers and directors of Maltby-Thurston Hotels Inc., during the period 1944 through 1949, were as follows their annual compensation being set forth behind their respective names:

1944 Directors	Officers	Annual Compensation
S. W. Thurston	S. W. Thurston, Pres. ....	Non
F. A. Dupar	F. A. Dupar, Vice Pres. ....	Non
T. E. Himmelman	T. E. Himmelman, Vice Pres. ....	Non
H. W. Casson	H. E. Maltby, Secretary-Treas. ....	Non
F. M. Kenney	H. W. Casson, Asst. Sec.-Treas. ....	Non
Chas. T. Donworth		
H. E. Maltby		

1945 Directors	Officers	Annual Compensation
S. W. Thurston	S. W. Thurston, Pres. ....	Non
F. A. Dupar	F. A. Dupar, Vice Pres. ....	Non
T. E. Himmelman	T. E. Himmelman, Vice Pres. ....	Non
H. W. Casson	H. E. Maltby, Secretary-Treas. ....	Non
F. M. Kenney	H. W. Casson, Asst. Sec.-Treas. ....	Non
Chas. T. Donworth		
H. E. Maltby		

1946 Directors	Officers	Annual Compensation
S. W. Thurston	S. W. Thurston, Pres. ....	Non
F. A. Dupar	F. A. Dupar, Vice Pres. ....	Non
T. E. Himmelman	T. E. Himmelman, Vice Pres. ....	Non
H. E. Maltby	H. E. Maltby, Sec.-Treas. ....	Non
Chas. T. Donworth	F. M. Kenney, Asst. Sec.-Treas. ....	Non



1947 Directors	Officers	Annual Compensations
S. W. Thurston	S. W. Thurston, Pres. ....	None
F. A. Dupar	F. A. Dupar, Vice Pres. ....	None
T. E. Himmelman	T. E. Himmelman, Vice Pres. ....	None
H. E. Maltby	H. E. Maltby, Sec.-Treas. ....	None
Chas. T. Donworth	F. M. Kenney, Asst. Sec.-Treas. ....	None

1948 Directors	Officers	Annual Compensations
S. W. Thurston	S. W. Thurston, Pres. ....	None
F. A. Dupar	F. A. Dupar, Vice Pres. ....	None
T. E. Himmelman	T. E. Himmelman, Vice Pres. ....	None
H. E. Maltby	H. E. Maltby, Sec.-Treas. ....	None
Chas. T. Donworth	F. M. Kenney, Asst. Sec.-Treas. ....	None

1949 Directors	Officers	Annual Compensations
S. W. Thurston	S. W. Thurston, Pres. ....	None
H. E. Maltby	F. A. Dupar, Vice Pres. and Asst. Treas. ....	None
F. A. Dupar	T. E. Himmelman, Vice Pres. ....	None
T. E. Himmelman	H. E. Maltby, Sec.-Treas. ....	None
Dewey W. Metzdorf	F. A. Weston, Asst. Sec. Treas. ....	None
Chas. T. Donworth		

9. The officers and directors of the petitioner, Multnomah Operating Company, for the years 1931 and 1944, through 1949, inclusive, are as follows, their compensations being set forth opposite their respective names:

1931 Directors	Officers	Annual Compensations
S. W. Thurston	S. W. Thurston, Pres. ....	\$ 4,500.00
John R. Latourette	E. V. Hauser, Vice Pres. ....	
F. A. Dupar	F. A. Dupar, Secretary.....	2,250.00
Peter G. Schmidt	Peter G. Schmidt, Treasurer.....	2,250.00
H. E. Maltby	H. E. Maltby, Asst. Sec. ....	
Earl V. Hauser		

1944 Directors	Officers	Annual Compensations
S. W. Thurston	S. W. Thurston, Pres. ....	\$10,200.00
F. M. Kenney	F. M. Kenney, Vice Pres. ....	4,500.00
F. A. Dupar	Earl McInnis, Vice Pres. ....	
	F. A. Dupar, Secretary.....	4,500.00
	H. E. Maltby, Treasurer.....	
	H. W. Casson, Asst. Treas. ....	

1945 Directors	Officers	Annual Compensations
S. W. Thurston	S. W. Thurston, Pres. ....	\$10,200.00
F. M. Kenney	F. M. Kenney, Vice Pres. ....	4,500.00
F. A. Dupar	Earl McInnis, Vice Pres. ....	
	F. A. Dupar, Secretary.....	4,500.00
	H. E. Maltby, Treasurer.....	
	H. W. Casson, Asst. Treas. ....	

1946 Directors	Officers	Annual Compensations
S. W. Thurston	S. W. Thurston, Pres. ....	\$10,200.00
F. M. Kenney	F. M. Kenney, Vice Pres. ....	4,500.00
F. A. Dupar	Earl McInnis, Vice Pres. ....	
	F. A. Dupar, Secretary.....	4,500.00
	H. E. Maltby, Treasurer.....	
	H. W. Casson, Asst. Treas. ....	

1947 Directors	Officers	Annual Compensations
S. W. Thurston	S. W. Thurston, Pres. ....	\$10,200.00
F. M. Kenney	F. M. Kenney, Vice Pres. ....	4,500.00
F. A. Dupar	Earl McInnis, Vice Pres. ....	
	F. A. Dupar, Secretary.....	4,500.00
	H. E. Maltby, Treasurer.....	
	F. A. Weston, Asst. Sec.-Treasurer.....	

1948 Directors	Officers	Annual Compensations
S. W. Thurston	S. W. Thurston, Pres. ....	\$10,200.00
F. M. Kenney	F. M. Kenney, Vice Pres. ....	4,500.00
F. A. Dupar	Gordon Bass, Vice Pres. ....	
	F. A. Dupar, Secretary.....	4,500.00
	H. E. Maltby, Treasurer.....	
	F. A. Weston, Asst. Treas. ....	

1949 Directors	Officers	Annual Compensations
S. W. Thurston	S. W. Thurston, Pres. ....	\$10,200.00
F. M. Kenney	F. M. Kenney, Vice Pres. ....	4,500.00
F. A. Dupar	Gordon Bass, Vice Pres. ....	15,318.72
	F. A. Dupar, Secretary.....	4,500.00
	H. E. Maltby, Treasurer.....	
	F. A. Weston, Asst. Treas. ....	1,500.00

10. The officers and directors of Western Hotels, Inc., for the years 1944 through 1949, inclusive, are as follows, their annual compensations being set forth behind their respective names:

1944 Directors	Officers	Annual Compensations
W. W. Thurston	S. W. Thurston, Pres. ....	\$26,250.00
F. M. Kenney	F. M. Kenney, Vice Pres. ....	14,430.00
F. A. Dupar	T. E. Himmelman, Vice Pres. ....	4,350.00
	F. A. Dupar, Secretary.....	15,100.00
	H. E. Maltby, Treasurer.....	11,650.00
	H. W. Casson, Asst. Sec.-Treas. ....	

1945 Directors	Officers	Annual Compensations
W. W. Thurston	S. W. Thurston, Pres. ....	\$29,700.00
F. M. Kenney	F. M. Kenney, Vice Pres. ....	15,230.00
F. A. Dupar	T. E. Himmelman, Vice Pres. ....	4,500.00
	F. A. Dupar, Secretary.....	17,150.00
	H. E. Maltby, Treasurer.....	12,200.00
	H. W. Casson, Asst. Sec.-Treas. ....	

1946 Directors	Officers	Annual Compensations
W. W. Thurston	S. W. Thurston, Pres. ....	\$31,335.50
F. M. Kenney	F. M. Kenney, Vice Pres. ....	15,749.00
F. A. Dupar	T. E. Himmelman, Vice Pres. ....	4,500.00
	F. A. Dupar, Secretary.....	18,067.75
	H. E. Maltby, Treasurer.....	12,677.75
	H. W. Casson, Asst. Sec.-Treas. ....	

1947 Directors	Officers	Annual Compensations
W. W. Thurston	S. W. Thurston, Pres. ....	\$28,400.00
F. M. Kenney	F. M. Kenney, Vice Pres. ....	16,180.00
F. A. Dupar	T. E. Himmelman, Vice Pres. ....	4,500.00
	E. E. Carlson, Vice Pres. ....	9,250.00
	C. W. Hunlock, Vice Pres. ....	3,600.00
	F. A. Dupar, Secretary.....	16,750.00
	H. E. Maltby, Treasurer.....	11,400.00

1948 Directors	Officers	Annual Compensation
S. W. Thurston	S. W. Thurston, Pres. ....	\$28,400
F. M. Kenney	F. M. Kenney, Vice Pres. ....	14,680
F. A. Dupar	T. E. Himmelman, Vice Pres. ....	4,500
	Dewey W. Metzdorf, Vice Pres. ....	
	C. W. Hunlock, Vice Pres. ....	3,600
	E. E. Carlson, Vice Pres. ....	9,500
	F. A. Dupar, Secretary.....	17,250
	H. E. Maltby, Treasurer.....	10,400
	F. A. Weston, Asst. Sec.-Treas. ....	

1949 Directors	Officers	Annual Compensation
S. W. Thurston	S. W. Thurston, Pres. ....	\$35,520
F. M. Kenney	F. M. Kenney, Vice Pres. ....	7,800
F. A. Dupar	T. H. Himmelman, Vice Pres. ....	16,040
	Dewey W. Metzdorf, Vice Pres. ....	10,560
	C. W. Hunlock, Vice Pres. ....	14,840
	E. E. Carlson, Vice Pres. ....	19,560
	F. A. Dupar, Secretary.....	27,280
	H. E. Maltby, Treasurer.....	9,000

11. The officers and directors for the Pacific Coast Investment Company, from 1944 through 1949, inclusive, are as follows, their annual compensations being set forth behind their respective names:

1944 Directors	Officers	Annual Compensation
F. M. Kenney	F. M. Kenney, Pres. ....	} (Records not available)
Peter G. Schmidt	A. C. C. Gamer, Vice Pres. ....	
A. C. C. Gamer	F. W. Schmidt, Secretary.....	
A. D. Schmidt		
F. W. Schmidt		

1945 Directors	Officers	Annual Compensation
F. M. Kenney	F. M. Kenney, Pres. ....	} (Records not available)
Peter G. Schmidt	A. C. C. Gamer, Vice Pres. ....	
A. C. C. Gamer	F. W. Schmidt, Secretary.....	
A. D. Schmidt		
F. W. Schmidt		

1946 Directors

F. M. Kenney  
Peter G. Schmidt  
A. C. C. Gamer  
A. D. Schmidt  
F. W. Schmidt

Officers

F. M. Kenney, Pres. ....	} (Records not available)
A. C. C. Gamer, Vice Pres. ....	
F. W. Schmidt, Secretary.....	

Annual  
Compensations

1947 Directors

F. M. Kenney  
Peter G. Schmidt  
A. C. C. Gamer  
A. D. Schmidt, Jr.  
F. W. Schmidt

Officers

F. M. Kenney, Pres. ....	} (Records not available)
A. C. C. Gamer, Vice Pres. ....	
F. W. Schmidt.....	

Annual  
Compensations

1948 Directors

F. M. Kenney  
F. A. Dupar  
S. W. Thurston

Officers

F. M. Kenney, Pres. ....	None
F. A. Dupar, Vice Pres. ....	None
S. W. Thurston, Sec.-Treas. ....	None
F. A. Weston, Asst. Sec.-Treas. ....	None

Annual  
Compensations

1949 Directors

F. M. Kenney  
F. A. Dupar  
S. W. Thurston

Officers

F. M. Kenney, President.....	None
F. A. Dupar, Vice President.....	None
S. W. Thurston, Sec'y-Treas. ....	None
F. A. Weston, Asst. Sec.-Treas. ....	None

Annual  
Compensations

/s/ HARRY HENKE, JR.,  
Counsel for Petitioner.

/s/ JOHN POTTS BARNES, R.E.M.,  
Chief Counsel, Internal Revenue Service, Counsel for  
Respondent.

Received July 18, 1955.

Filed August 19, 1955, T.C.U.S.



[Title of Tax Court and Cause.]

SUPPLEMENTAL STIPULATION  
OF FACTS

At the request of counsel for respondent and pursuant to agreement before counsel for both parties, the following facts are hereby stipulated and entered into the record of this proceeding in order to supplement the Stipulation of Facts in this proceeding:

1. Adeline G. Metzdorf, the beneficial owner of one thousand shares of the stock of Maltby-Thurston Hotels, Inc., a Washington corporation, held in a voting trust, is the wife of Dewey W. Metzdorf.

2. The said Adeline G. Metzdorf is not an employee, officer or director of either Maltby-Thurston Hotels, Inc., Multnomah Operating Co., Western Hotels, Inc., or Pacific Coast Investment Co.

3. The said Adeline G. Metzdorf is not related to any other individual holding stock in the Maltby-Thurston Hotels, Inc., voting trust.

Dated this . . . . day of August, 1955.

/s/ HARRY HENKE, JR.,  
Counsel for Petitioner.

/s/ JOHN POTTS BARNES, R.E.M.  
Chief Counsel, Internal Revenue Service, Counsel  
for Respondent.

Filed August 19, 1955, T.C.U.S.



[Title of Tax Court and Cause.]

MEMORANDUM FINDINGS OF FACT  
AND OPINION

Withey, Judge:

The Commissioner has determined a deficiency against the petitioner, Multnomah Operating Co., in the amount of \$11,805.43 for the year 1948 and \$11,530.56 for the year 1949.

The sole issue for our determination is whether or not certain payments made in each year by petitioner constituted deductible business expenses under section 23(a)(1)(A) of the Internal Revenue Code of 1939.

Findings of Fact

Stipulated facts are so found.

Petitioner, Multnomah Operating Co., hereinafter referred to at times as Multnomah, is a corporation with its principal office and place of business in Seattle, Washington. It filed income tax returns for the calendar years 1948 and 1949 with the collector for the district of Washington.

Petitioner was incorporated in 1931 with a paid-in capital of \$1,000 which was represented by 250 shares of common stock. On the following dates, these shares were held as listed:

Shareholder	July 1 1931	January 1944	January 1948	January 1949
A. P. Bassett.....	15	15	15	15
A. D. Belanger .....	15	—	—	—
F. A. Dupar & Peoples Natl. Bank, Coexecutors under Will of A. P. Bassett.....	—	—	—	5
Frank A. Dupar.....	17	1½	1½	101½
H. E. Dupar.....	15	—	—	—
H. E. Dupar and F. A. Dupar, Trustees .....	—	15	15	—
Eric V. Hauser.....	1	—	—	—
F. M. Kenney—qualifying share Pacific Coast Investment Co.....	—	1	1	1
John R. Latourette.....	1	—	—	—
Maltby-Thurston Hotels, Inc.....	123	—	—	—
Peter G. Schmidt, Trustee.....	62	—	—	—
S. W. Thurston—qualifying share Maltby-Thurston Hotels, Inc.....	1	1	1	1
Voting Trust—in existence from May 1, 1940, to April 30, 1950....	—	217½	217½	217½
Total .....	250	250	250	250
	==	==	==	==

During the period 1944 through 1949 voting control of petitioner rested in the members of a voting trust, the identity and stock contributions to the trust of such members being as follows:

Multnomah Operating Co.

Members of Voting Trust from May 1, 1940, to May 1, 1950

	1944	1948	1949
F. A. Dupar.....	17	17	17
H. E. Dupar.....	15	—	—
Maltby-Thurston Hotels, Inc.....	124	124	124
Pacific Coast Investment Co.....	61½	61½	61½
Seattle First National Bank, Trustee under Will of H. E. Dupar, deceased	—	15	15
Total .....	217½	217½	217½
	==	==	==

The total outstanding stock of the Maltby-Thurston Hotels, Inc., hereinafter referred to as Maltby, was as shown below in the following tabulations. These shares were held as follows on the following dates:

Maltby-Thurston Hotels, Inc.

Principal Stockholders	Common Stock	July 1, 1931 Class A Stock	Preferred Stock
Troy E. Himmelman.....	1,991 $\frac{2}{3}$	32	791 $\frac{1}{2}$
F. M. Kenney.....	1	—	—
Harold Emery Maltby.....	6,569	1,260	1961 $\frac{1}{4}$
Pacific Coast Investment Company .....	—	—	11 $\frac{1}{4}$
S. W. Thurston.....	10,153 $\frac{1}{4}$	120	1881 $\frac{1}{2}$
Subtotal .....	18,714 11/12	1,412	4651 $\frac{1}{2}$
Frank D. or Blanche Bruce....	1,459	150	29
H. E. Lutz.....	2,042	70	175
Earl McInnes .....	1,566 $\frac{2}{3}$	35	89
Hy D. Miller.....	—	—	150
Total .....	23,782 7/12	1,667	9081 $\frac{1}{2}$
Stock outstanding on dates indicated above .....	31,298 $\frac{3}{4}$	4,1861 $\frac{1}{2}$	4,756

	Jan. 1, 1944 Common Stock	Jan. 1, 1948 Common Stock	Jan. 1, 1949 Common Stock
Frank A. Dupar.....	0	856	1,178
T. E. Himmelman.....	775	797	836
F. M. Kenney.....	45	70	70
Harold Emery Maltby.....	100	525	525
Dewey W. Metzdorf.....	—	172	172
Pacific Coast Investment Company .....	5111 $\frac{1}{4}$	5111 $\frac{1}{4}$	5111 $\frac{1}{4}$
S. W. Thurston .....	261 $\frac{1}{4}$	184 $\frac{3}{4}$	300 $\frac{3}{4}$
Voting Trust .....	15,9951 $\frac{1}{2}$	15,112	15,112
Subtotal .....	17,453	18,228	18,705

	Jan. 1, 1944 Common Stock	Jan. 1, 1948 Common Stock	Jan. 1, 1949 Common Stock
Frank D or			
Blanche Bruce .....	1,569 $\frac{1}{4}$	1,569 $\frac{1}{4}$	1,569 $\frac{1}{4}$
H. E. Lutz.....	1,689 $\frac{1}{4}$	1,689 $\frac{1}{4}$	1,689 $\frac{1}{4}$
Earl McInnes .....	668 $\frac{2}{3}$	668 $\frac{2}{3}$	668 $\frac{2}{3}$
Hy D. Miller.....	344	—	—
Total .....	21,724 $1\frac{1}{6}$	22,155 $1\frac{1}{6}$	22,632 $1\frac{1}{6}$
Stock outstanding on dates indicated above .....	27,528	30,323	30,401

## Maltby-Thurston Hotels, Inc.

## Stock in Voting Trust

	Jan. 1, 1944	Jan. 1948	Jan. 1949
Frank A. Dupar.....	267	267	267
T. E. Himmelman.....	1,737	1,737	1,737
F. M. Kenney.....	108	108	108
H. E. Maltby.....	5,725 $\frac{1}{4}$	5,000	5,000
Adeline G. Metzdorf.....	—	1,000	1,000
Dewey W. Metzdorf.....	—	828	828
S. W. Thurston.....	8,158 $\frac{1}{4}$	6,172	6,172
Total .....	15,995 $\frac{1}{2}$	15,112	15,112

Western Hotels, Inc., hereinafter referred to as Western, was incorporated about 1930 as a hotel service organization rendering general services to all hotels for a consideration. It represented an effort on the part of Maltby, Pacific Coast Investment Co., hereinafter referred to for convenience as PCI, and Frank A. Dupar who had previously been competitors to thereafter cease competition and act in concert to their mutual benefit in the hotel business. Western's total capital stock during 1931 consisted of 5,630 shares which was reduced to 100 shares in 1934. Its stock was held as follows on the indicated pertinent dates:

Western Hotels, Inc.

Shareholders	July 1 1931	January 1944	January 1948	January 1949
A. D. Belanger.....	1	—	—	—
Byron Hotel Co. ....	519	—	—	—
Capital Hotel Co. ....	558	—	—	—
H. W. Casson.....	1	—	—	—
Chas. T. Donworth.....	1	—	—	—
Frank A. Dupar.....	1	25	25	25
Elman Hotel Co. ....	299	—	—	—
Exchange Investment Co. ....	179	—	—	—
F. M. Kenney.....	1	—	—	—
H. E. Maltby.....	1	—	—	—
Maltby-Thurston Hotels, Inc.	2,886	50	50	50
Hy D. Miller.....	1	—	—	—
Carl E. Morek.....	1	—	—	—
Morek Hotel Co. ....	299	—	—	—
John C. Pierce.....	1	—	—	—
Thad S. Pierce.....	1	—	—	—
Adolph D. Schmidt.....	1	—	—	—
Peter G. Schmidt.....	1	—	—	—
S. W. Thurston.....	1	—	—	—
Washington Hotel Co. ....	499	—	—	—
West Coast Hotel Co. ....	378	—	—	—
Pacific Coast Investment Co.	—	25	25	25
Total .....	5,630	100	100	100

The total outstanding stock of PCI was at all times 600,000 shares which were held on July 1, 1931, as follows:

Pacific Coast Investment Co.

July 1, 1931

Stockholders	Number of shares held
J. Duttonhoefer .....	1,008
W. J. Foster .....	540
W. B. Gaffney, Estate .....	2,400

A. C. C. Gamer .....	220
Henry Schupp .....	5,040
Larabie Stock Co. ....	78,246
Julia W. Larabie .....	9,601
C. Ted Larabie .....	2,400
Mary Ann Larabie .....	2,400
Lucien Larabie .....	2,400
Elizabeth Larabie .....	2,400
Sue M. Larabie .....	2,400
Fred Stocking .....	1,231
P. M. Troy .....	1,231
Sams V. Peters .....	270
Schmidt Estate, Inc. ....	348,506
Peter G. Schmidt .....	14,401
Mrs. Peter G. Schmidt .....	500
Frank T. Schmidt .....	7,200
Frederick W. Schmidt .....	905
Joe R. Speckart .....	37,472
J. H. Rohrbeck .....	1
F. M. Kenney .....	6,001
Toba Harris .....	6,000
N. P. Faris .....	135
Emma M. Foreman .....	12,906
Lena R. Gamer .....	25,812
C. E. Larabie .....	1,200
Mrs. R. D. Larabie .....	3,600
Emmy Mailand .....	5,334
U. S. National Bank of Portland, Trustee ..	5,334
Dorothy L. Gamer .....	6,453
Leland S. Gamer .....	6,453

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Total number of shares issued ..... 600,000

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on January 1, 1944, as follows:

Pacific Coast Investment Co.

January 1, 1944

Stockholder	Number of Shares Held
Dr. Marie D. Equi .....	5,334
Blanche Gaffney .....	1,200
F. M. Kenney .....	92,371
Frank J. Kenney .....	2,500
Janet Lee .....	2,500
Helen Malloy .....	2,500
Grace Mallory .....	2,500
Emma M. Foreman .....	25,812
W. J. Foster .....	540
Olive B. Gaffney .....	1,200
A. C. C. Gamer .....	12,906
Dorothy L. Gamer .....	6,573
Leland L. Gamer .....	6,553
Irene Hannah .....	6,000
F. M. Kenney, Peter G. Schmidt, Trustees for Paula Speckart .....	37,472
Mrs. R. D. Larabie .....	3,600
Caroline Schmidt Maury .....	4,000
J. C. Sams .....	270
Phillipine S. Rettenmeyer .....	62,175
Adolph Schmidt .....	42,175
Clara M. Schmidt, Trustee .....	20,000
Clara M. Schmidt, Personal .....	500
Louise W. Schmidt .....	62,179
Peter G. Schmidt, Frank T. Schmidt, J. B. Peyton, Trustees for Elsa Schmidt .....	63,080

Stockholder	Number of Shares Held
Peter G. Schmidt, Personal .....	42,175
Frank T. Schmidt, Trustee .....	70,383
Adolph Schmidt, Jr. ....	4,000
Robert A. Schmidt .....	4,000
Truman L. Schmidt .....	4,000
Philip H. Schmidt .....	4,000
Katherine Schupp .....	5,040
Alma Stocking .....	1,231
Smith Troy .....	1,231
<hr/>	
Total number of shares issued .....	600,000
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on January 1, 1948, as follows:

Pacific Cost Investment Co.

January 1, 1948

Stockholder	Number of Shares Held
Maltby-Thurston Hotels, Inc .....	471,983
F. M. Kenney .....	471,983
Frank J. Kenney .....	4,500
Irene Kenney .....	2,000
Janet Lee .....	4,500
Dr. Marie D. Equi .....	5,334
Helen A. Malloy .....	4,600
Grace Mallory .....	4,500
New Washington Hotel Co. ....	19,112
Olive B. Gaffney .....	1,200
<hr/>	
Total number of shares issued ....	600,000
<hr/> <hr/>	

and on January 1, 1949, as follows:

**Pacific Coast Investment Co.**

**January 1, 1949**

Stockholder	Number of Shares Held
Maltby-Thurston Hotels, Inc. ....	433,522
New Washington Hotel Co. ....	58,773
Dr. Marie Equi .....	5,334
F. M. Kenney .....	81,371
Frank J. Kenney .....	4,500
Janet Lee .....	4,500
Irene Kenney .....	2,000
Helen A. Malloy .....	4,600
Mark A. Malloy .....	900
Grace Mallory .....	4,500
	<hr/>
Total stock issued .....	600,000
	<hr/> <hr/>

The officers and directors of Maltby during the period 1944 through 1949 were as follows:

**1944, 1945**

**Directors:**

S. W. Thurston,

F. A. Dupar,

T. E. Himmelman,

H. E. Maltby,

H. W. Casson,

Chas. T. Donworth,

F. M. Kenney.

## Officers:

S. W. Thurston, Pres.;  
F. A. Dupar, Vice Pres.;  
T. E. Himmelman, Vice Pres.;  
H. E. Maltby, Sec.-Treas.;  
H. W. Casson, Asst. Sec.-Treas.

1946, 1947, 1948

## Directors:

S. W. Thurston,  
F. A. Dupar,  
T. E. Himmelman,  
H. E. Maltby,  
Chas. T. Donworth.

## Officers:

S. W. Thurston, Pres.;  
F. A. Dupar, Vice Pres.;  
T. E. Himmelman, Vice Pres.;  
H. E. Maltby, Sec.-Treas.;  
F. M. Kenney, Asst. Sec.-Treas.

1949

## Directors:

S. W. Thurston,  
F. A. Dupar,  
T. E. Himmelman,  
H. E. Maltby,  
Chas. T. Donworth,  
Dewey W. Metzdorf.

## Officers:

S. W. Thurston, Pres.;  
F. A. Dupar, Vice Pres. and Asst. Treas.;

T. E. Himmelman, Vice Pres. ;  
H. E. Maltby, Sec.-Treas. ;  
F. A. Weston, Asst. Sec.-Treas.

The officers and directors of the petitioner, Multnomah, for the years 1931 and 1944 through 1949, inclusive, were as follows:

1931

Directors:

S. W. Thurston,  
Earl V. Hauser,  
F. A. Dupar,  
Peter G. Schmidt,  
H. E. Maltby,  
John R. Latourette.

Officers:

S. W. Thurston, Pres. ;  
E. V. Hauser, Vice Pres. ;  
F. A. Dupar, Secretary ;  
Peter G. Schmidt, Treasurer ;  
H. E. Maltby, Asst. Sec.

1944, 1945, 1946

Directors:

S. W. Thurston,  
F. M. Kenney,  
F. A. Dupar.

Officers:

S. W. Thurston, Pres. ;  
F. M. Kenney, Vice Pres. ;  
Earl McInnis, Vice Pres. ;

F. A. Dupar, Secretary;  
H. E. Maltby, Treasurer;  
H. W. Casson, Asst. Treas.

1947

Directors:

S. W. Thurston,  
F. M. Kenney,  
F. A. Dupar.

Officers:

S. W. Thurston, Pres.;  
F. M. Kenney, Vice Pres.;  
Earl McInnis, Vice Pres.;  
F. A. Dupar, Secretary;  
H. E. Maltby, Treasurer;  
F. A. Weston, Asst. Sec.-Treas.

1948, 1949

Directors:

S. W. Thurston,  
F. M. Kenney,  
F. A. Dupar.

Officers:

S. W. Thurston, Pres.;  
F. M. Kenney, Vice Pres.;  
Gordon Bass, Vice Pres.;  
F. A. Dupar, Secretary;  
H. E. Maltby, Treasurer;  
F. A. Weston, Asst. Treas.



The officers and directors of Western for the years 1944 through 1949, inclusive, were as follows:

1944, 1945, 1946

**Directors:**

S. W. Thurston,  
F. M. Kenney,  
F. A. Dupar.

**Officers:**

S. W. Thurston, Pres.;  
F. M. Kenney, Vice Pres.;  
T. E. Himmelman, Vice Pres.;  
F. A. Dupar, Secretary;  
H. E. Maltby, Treasurer;  
H. W. Casson, Asst. Sec.-Treas.

1947

**Directors:**

S. W. Thurston,  
F. M. Kenney,  
F. A. Dupar.

**Officers:**

S. W. Thurston, Pres.;  
F. M. Kenney, Vice Pres.;  
T. E. Himmelman, Vice Pres.;  
E. E. Carlson, Vice Pres.;  
C. W. Hunlock, Vice Pres.;  
F. A. Dupar, Secretary;  
H. E. Maltby, Treasurer.

1948

## Directors:

S. W. Thurston,  
F. M. Kenney,  
F. A. Dupar.

## Officers:

S. W. Thurston, Pres.;  
F. M. Kenney, Vice Pres.;  
T. E. Himmelman, Vice Pres.;  
Dewey W. Metzdorf, Vice Pres.;  
C. W. Hunlock, Vice Pres.;  
E. E. Carlson, Vice Pres.;  
F. A. Dupar, Secretary;  
H. E. Maltby, Treasurer;  
F. A. Weston, Asst. Sec.-Treas.

1949

## Directors:

S. W. Thurston,  
F. M. Kenney,  
F. A. Dupar.

## Officers:

S. W. Thurston, Pres.;  
F. M. Kenney, Vice Pres.;  
T. H. [sic] Himmelman, Vice Pres.;  
Dewey W. Metzdorf, Vice Pres.;  
C. W. Hunlock, Vice Pres.;  
E. E. Carlson, Vice Pres.;  
F. A. Dupar, Secretary;  
H. E. Maltby, Treasurer.

The officers and directors for PCI from 1944 through 1949, inclusive, were as follows:

1944, 1945, 1946

Directors:

F. M. Kenney,  
Peter G. Schmidt,  
A. C. C. Gamer,  
A. D. Schmidt,  
F. W. Schmidt.

Officers:

F. M. Kenney, Pres.;  
A. C. C. Gamer, Vice Pres.;  
F. W. Schmidt, Secretary.

1947

Directors:

F. M. Kenney,  
Peter G. Schmidt,  
A. C. C. Gamer,  
A. D. Schmidt, Jr.,  
F. W. Schmidt.

Officers:

F. M. Kenney, Pres.;  
A. C. C. Gamer, Vice Pres.;  
F. W. Schmidt.

1948, 1949

Directors:

F. M. Kenney,  
F. A. Dupar,  
S. W. Thurston.

**Officers:**

F. M. Kenney, Pres.;

F. A. Dupar, Vice Pres.;

S. W. Thurston, Sec.-Treas.;

F. A. Weston, Asst. Sec.-Treas.

The Multnomah voting trust stock was votable by S. W. Thurston, Frank Dupar and F. M. Kenney on behalf of PCI in that order conditioned upon whether he who had the primary right so to do died, became incapacitated, unwilling or unable to vote the stock. The Maltby voting trustees in 1948 and 1949 were H. E. Maltby, S. W. Thurston, T. E. Himmelman, Frank A. Dupar and F. M. Kenney.

By a lease, dated June 17, 1931, negotiated at arm's length, Hauser Securities Company leased the Multnomah Hotel in Portland, Oregon, to Maltby for a term of 15 years commencing July 1, 1931, and ending July 1, 1946. The lease rental consisted of a minimum fixed monthly rental of \$7,000 per month and a designated percentage of gross revenue. No bonus or consideration other than this rental was paid to the lessor.

The lease, inter alia, provided:

This lease to a large extent is based upon the personnel of the present officers of said Lessee and their ability to conduct and operate a first-class hotel and by reason thereof Lessee covenants and agrees not to assign this lease nor sublet nor underlet nor permit any other person or persons to

occupy said premises other than the employees and patrons of said Lessee without the consent of said Lessor being first obtained in writing. \* \* \* (Provided further that it is understood and agreed that the within Lessee contemplates the forming of an Oregon corporation to whom the within lease may be assigned by it, the majority of the personnel of which will be the same as that of the within named Lessee and/or Western Hotels, Inc., and Lessor consents to the within named Lessee assigning the within lease to said corporation to be duly formed providing that said assignment shall be subject to all of the terms, covenants and conditions of the within lease and with the consent that the demised premises are only to be used for the purposes herein stated and that the within consent shall in nowise alter, change or modify any term, covenant, provision or condition hereof nor shall this consent be continuing or extended to any other person, firm or corporation; provided further that said assignee shall in a form entirely satisfactory to the within named Lessor accept said assignment and agree to be bound by all the terms, covenants and conditions of the within lease; that this consent of assignment is limited to the one assignment herein stated, and after such assignment all liability of the within Lessee shall be at an end.)

The lessor required the deposit of security for the performance by petitioner of the lease provisions. To that end Maltby issued to petitioner \$75,000 of its preferred stock which petitioner

agreed to purchase. Petitioner in turn deposited the stock as security with the lessor. PCI, through its trustee, Peter G. Schmidt, and Frank Dupar each guaranteed to Maltby in writing that petitioner would pay the par value of 25 per cent of such stock. Each was required at an undisclosed time to pay the amount so guaranteed for which payment each was subsequently reimbursed by petitioner.

On June 30, 1931, Maltby assigned its interest as lessee to petitioner, said assignment being assented to by the lessor. The assignment was therein stated to be "For One Dollar (\$1.00) and other good and valuable consideration."

The lease had been in negotiation for a period of approximately 10 months prior to its execution. The negotiators had been Dupar, Peter Schmidt and S. W. Thurston, who met with Hauser for negotiation approximately twenty times. At the time of assignment of the lease to petitioner, Dupar insisted upon compensation for his services rendered in the negotiations for the lease, for his guarantee of payment of par value of 25 per cent of the Maltby stock placed with the lessor as security by petitioner, and for what he alleged was his interest in the lease. It was agreed between Maltby, PCI and Dupar that petitioner would pay to them for the assignment of the lease of the hotel premises the amount of \$2,500 per month after payment of the fixed and percentage rentals required by the lease terms. Of this amount, Dupar insisted that he



receive \$625 per month as such compensation. The remainder, it was agreed, would be divided between PCI and Maltby in proportion to their respective stock holdings in petitioner. These payments were provided for by a separate written agreement between petitioner and Maltby entered into simultaneously with the assignment of the lease. Except for an undisclosed but short period of time immediately following inception, these payments have been made throughout the term of the lease and the extension thereof.

At the time the lease was executed the Multnomah Hotel was in bad repair, and it was apparent that large expenditures would be required in order to make it a profitable business asset. To that end, the lease required the expenditure by petitioner of \$21,600 per year over and above all other amounts or that such portion of that amount not so spent be paid to the lessor.

The original lease terminated by its provisions July 1, 1946, but an extension was sought by petitioner as early as 1940 when it became apparent that negotiations by others were in progress in Portland looking toward the construction of a new hotel. Without the expenditure of about \$400,000 for re-equipment, remodeling and redecorating, petitioner's hotel could not withstand the competition of a new hotel. Before making such an investment, therefore, petitioner desired an extension of its lease. Negotiations for the lease extension were carried on

by S. W. Thurston and Dupar, Schmidt having taken no part therein. Ultimately an extension agreement was executed directly between petitioner and the owner of the hotel property. This agreement, dated February 4, 1944, extended the term of the original lease to July 1, 1961, and provided for an increase of the minimum fixed rental to \$8,500 per year. All of the terms and conditions of the original lease remained in full force and effect under the extension agreement, including the provision that the officers and personnel of petitioner were to be the same as Maltby or Western. Simultaneously petitioner and Hauser entered into a separate written agreement whereby provision was made for replacement of the original security of \$75,000 of Maltby preferred stock with a like amount of the common stock of that corporation which was to be forfeited to Hauser as liquidated damages in case of petitioner's default in the lease terms. This was stock purchased and owned by petitioner.

By an agreement between Maltby and Western, as first parties, and petitioner, as second party, dated February 3, 1944, petitioner agreed to continue the payments to Dupar, Maltby and PCI at the rate of \$625, \$1,250 and \$625, respectively, throughout the extended term of petitioner's lease. The consideration therein stated for such extension of the payments is the agreement of said payees to accede to the lease extension at a higher minimum rental before the expiration of the original lease, the

agreement of Maltby that its officers and personnel or that of Western would continue to operate the Multnomah Hotel, and the services of Maltby, Western and Frank Dupar in securing through negotiation the lease extension agreement. Peter G. Schmidt, as trustee of PCI, did not in fact aid in the procurement of the extension agreement. However, he and Dupar each approved the last mentioned agreement by their signatures.

### Opinion

In its petition, its opening argument and on brief, petitioner has sought to limit the issue before us to the sole question of whether or not under section 23(a)(1)(A) of the 1939 Code<sup>1</sup> the amounts in controversy are properly deductible for the years

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<sup>1</sup>Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.

(1) Trade or business expenses.

(A) In general—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

1948 and 1949 as rentals or other amounts necessary for petitioner's use and occupancy of the Multnomah Hotel property. Respondent, on the other hand, takes the view that such amounts are in reality nothing more nor less than distributions in the nature of guaranteed dividends to stockholders of petitioner and generally has determined that they are not deductible as ordinary and necessary business expense.

That the amounts involved, which were paid on either a monthly or a quarterly basis, totaling \$2,500 per month, to Maltby, PCI and Dupar, hereinafter collectively referred to as payees, were not rentals, even though so designated in written contracts between the three payees and petitioner, we think is fairly obvious. In the light of the testimony of Dupar and S. W. Thurston who represented Maltby in all the transactions here involved, it is clear that the basis for the payments was services rendered by the three payees prior to the execution of the original lease in 1931 and also prior to the execution of the renewal agreement in 1944 and for services to be rendered thereafter during the term of the lease and its renewal. Petitioner, in contending that such payments were rentals and in attempting to show adequate consideration, therefore, urges that they were actually compensation for such services rendered in the past and to be rendered throughout the term of the lease. That being true, we cannot conclude otherwise than that such payments were not rentals.



We conclude from the facts as found that all the transactions referred to in such findings, with the exception of the lease and the renewal thereof negotiated with Hauser, were not arrived at on an arm's length basis. We must therefore scrutinize such transactions closely with respect to whether or not the controversial payments are "other payments required to be made as a condition to the continued use" of the hotel premises. The test, of course, lies in the answer to the question as to the likelihood or probability of an interruption in petitioner's use of such property in case it should default in such payments. The facts show clearly a close relationship between the three payees here involved and petitioner. Through a voting trust arrangement, they controlled petitioner. They were the parents responsible for its birth. As of the date of renewal of the lease, through their efforts, petitioner had become an increasingly valuable asset with bright prospects for its future. We do not think it is realistic to conclude that the three payees would have refused longer to render the services required of them in petitioner's operation under the lease in the event of default in the payment of the amounts in controversy, although concededly such default otherwise could have resulted in violation of the terms of the lease through the payees' refusal to longer render the operational services therein required.

We are impressed however that this record fully substantiates the conclusion that whatever the peti-

tioner has named the amounts sought to be deducted, they were compensation for services rendered in the ordinary course of petitioner's business within the meaning of section 23(a)(1)(A). While respondent does contend that the \$2,500 monthly payments are in excess of the true rental value of the hotel premises, he makes no contention that they are excessive or unreasonable as compensation. We think that, in the light of the long experience of all three payees in the hotel business and in view of their efforts in the negotiating of the original lease and the efforts of Dupar and Maltby in the negotiating of the renewal thereof, together with other services required of one or the other of them under the lease and its extension and agreements in pursuance thereof, such compensation is not unreasonable. Accordingly, we hold that the payments in question were deductible by petitioner.

Decision will be entered under Rule 50.

Received February 14, 1956, T.C.U.S.

Served March 2, 1956.



[Title of Tax Court and Cause.]

MOTION TO VACATE AND REVIEW OPINION BY FULL COURT PURSUANT TO SECTION 7460(b) INTERNAL REVENUE CODE OF 1954

Comes Now the respondent, by his attorney, John Potts Barnes, Chief Counsel, Internal Revenue Service, and moves that the Opinion in the above-entitled case, filed February 23, 1956, be vacated, and that, pursuant to Section 7460(b), Internal Revenue Code of 1954, the Chief Judge order that the opinion be reviewed by the full Court; and, in support of this motion, respectfully represents to the Court that this Opinion involves novel questions of law, is in conflict with other decisions of this Court, is self-contradicting, and is contrary to the stipulated facts and the law of the case, as hereinafter set forth:

1. The Opinion decides a novel question in holding that a court may allow a deduction under a provision of Section 23(a)(1)(A), Internal Revenue Code of 1939, that is separate and distinct from the provision pleaded and argued on briefs by both parties, without affording the opposing party any notice or any opportunity to present evidence or argue the provision on brief.

2. In the holding set forth in the immediately preceding paragraph, the Court implicitly holds, contrary to Rule 7(b)(4) of Rules of Practice Be-

fore the Tax Court of the United States, that in a petition to this Court it is sufficient to allege Section 23(a)(1)(A), Internal Revenue Code of 1939, generally, without specifying any provision thereof.

3. The Opinion conflicts with the numerous decisions in which this Court refused to consider issues not raised by the pleadings. In the instant case, the issue was not raised by the pleadings or by the briefs, but raised for the first time by the Court in its Opinion. *F. H. Wilson* (1928) 12 B.T.A. 403, at 406; *William Bernstein* (Feb. 8, 1952) Memo Op. Docket 29332; *James B. Lowell* (1927) 9 B.T.A. 62, at 65; *Edward S. Phillips* (1927) 9 B.T.A. 1016, at 1019; *Coosa Land Co.* (1933) 29 B.T.A. 389, at 394; *Camp Wolters Land Co.* (1945) 5 T.C. 336, at 347 (Reviewed by the Court), *aff'd.* in part and *rev'd* and remanded in part on other issues. (C.C.A. 5th 1947), 160 F. 2d 84, 35 A.F.T.R. 873; *Welch, Holme & Clark Co.* (1928) 14 B.T.A. 148, at 154; see also *Standard Galvanizing Co. vs. Com.* (C.A. 7th 1953) 202 F. 2d 736, at 739, 43 A.F.T.R. 434 *rev'g.* and remanding *Standard Galvanizing Co. (of Illinois)* (Feb. 25, 1952) Memo Op. Docket 24015.

4. The Opinion conflicts with other decisions of this Court in holding that a sum paid by a corporation to its stockholders may be deducted as compensation under Section 23(a)(1)(A), Internal Revenue Code of 1939, where the stockholder rendered no services. (See the last two sentences in the Findings of Fact, p. 18, and the last two sentences of the Opinion, p. 21, regarding Peter G.

Schmidt (trustee for Pacific Coast Investment Co.) who rendered no services for the sums in question paid to him.)

5. The Opinion conflicts with other decisions of this Court in holding that a sum paid by a corporation and allocated by it amongst its stockholders is deductible as compensation under Section 23(a)(1)(A), Internal Revenue Code of 1939, where the sum is not allocated on the basis of services rendered, but on the basis of stockholdings. (Findings of Fact, p. 16, line 4.) See D. H. Willey Lumber Co. (June 29, 1948) Memo Op. Docket 10864, et al., aff'd. per curiam (C.A. 6th 1949) 177 F. 2d 200, 38 A.F.T.R. 758.

6. The Opinion conflicts with Rule 32 of Rules of Practice Before the Tax Court of the United States and with the fundamental decisions and principles of this Court pertaining to burden of proof in finding a total sum to be reasonable compensation within the meaning of Section 23(a)(1)(A), Internal Revenue Code of 1939, where the taxpayer admits in testimony that it is unable to state how the total sum to be paid was determined or whether it was arbitrarily determined, and the record is devoid of evidence to establish how the total sum was arrived at (Tr. 42, 44, 45, 59, 60).

7. The Opinion and the Findings of Fact contradict each other. The conclusion in the Opinion that the sums in question were compensation paid by the petitioner to the individuals mentioned contra-

dicts paragraph 9 of the Stipulation of Facts wherein the parties stipulated the amount of compensation paid by the petitioner to these individuals. In the Findings of Fact, first sentence, p. 2, it is stated: "Stipulated facts are so found."

Wherefore, it is prayed that this motion be granted.

/s/ JOHN POTTS BARNES, R.E.M.,  
Chief Counsel,  
Internal Revenue Service.

Denied March 22, 1956, J. Murdock, Judge.

Received and filed March 21, 1956, T.C.U.S.

Served March 30, 1956.

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[Title of Tax Court and Cause.]

AMENDMENT TO MOTION TO VACATE AND  
REVIEW OPINION BY FULL COURT  
PURSUANT TO SECTION 7460(b) IN-  
TERNAL REVENUE CODE OF 1954

Comes Now the respondent, by his attorney, John Potts Barnes, Chief Counsel, Internal Revenue Service, and moves that the respondent's Motion to Vacate and Review Opinion by Full Court Pursuant to Section 7460(b), Internal Revenue Code of 1954, be amended by adding the following paragraphs at page 4 after paragraph 7 and before the Wherefore clause:

8. The conclusions that the sum in question was compensation and that it was reasonable in amount is patently erroneous when it is noted that this sum amounts to \$900,000 (\$30,000 per year for 30 years); and further, that \$450,000, or one-half of this sum, would relate only to renewing the lease.

9. Messrs. Frank Dupar and S. W. Thurston were officers and directors of the petitioner and acted in that capacity when renewing the lease. They were receiving compensation from the petitioner for their services in these capacities (Stipulation, par. 9) and there is no evidence that this compensation was less than reasonable or that it was inadequate for the services rendered in renewing the lease.

/s/ JOHN POTTS BARNES, R.E.M.,  
Chief Counsel,  
Internal Revenue Service.

Denied March 22, 1956, J. Murdock, Judge.

Filed March 21, 1956, T.C.U.S.

Served March 30, 1956.



The Tax Court of the United States  
Washington

Docket No. 52071

MULTNOMAH OPERATING CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the Memorandum Findings of Fact and Opinion filed herein February 23, 1956, directing that decision be entered under Rule 50, the parties, filed on June 12, 1956, an agreed computation for entry of decision. In accordance therewith, it is

Ordered and Decided: That there are deficiencies in income tax for 1948 and 1949 in the respective amounts of \$405.43 and \$130.56.

[Seal]     /s/ G. G. WITHEY,  
                    Judge.

Served June 14, 1956.

Entered June 14, 1956.



United States Court of Appeals  
for the Ninth Circuit

T. C. Docket No. 52071

COMMISSIONER OF INTERNAL REVENUE,

Petitioner on Review,

vs.

MULTNOMAH OPERATING CO.,

Respondent on Review.

PETITION FOR REVIEW

To: The Honorable Judges of the United States  
Court of Appeals for the Ninth Circuit:

The Commissioner of Internal Revenue hereby petitions the United States Court of Appeals for the Ninth Circuit to review the decision entered by the Tax Court of the United States on June 13, 1956, ordering and deciding that there are deficiencies in income tax for 1948 and 1949 in the respective amounts of \$405.43 and \$130.56. This petition for review is filed pursuant to the provisions of Sections 7482 and 7483 of the Internal Revenue Code of 1954.

The respondent on review (hereinafter referred to as the taxpayer) is a corporation with its principal office and place of business in Seattle, Washington. The taxpayer filed its United States corporation income tax returns for the calendar years 1948 and 1949 with the Collector of Internal Rev-

enue for the District of Washington, and within the judicial circuit of the United States Court of Appeals for the Ninth Circuit, wherein this review is sought.

### Nature of Controversy

The question presented was whether the \$30,000 paid by the taxpayer to three controlling stockholders in each of the taxable years 1948 and 1949 represented rent deductible as a business expense under Sec. 23(a)(1)(A), Internal Revenue Code of 1939, as contended by the taxpayer, or distributions of profits in the nature of dividends as contended by the Commissioner. The Tax Court decided against the Commissioner and held that the amounts sought to be deducted were compensation for services rendered in the ordinary course of taxpayer's business within the meaning of section 23(a)(1)(A); that such compensation is not unreasonable; and that therefore the payments in question were deductible by the taxpayer. The Commissioner's motion, and amendment to motion, to vacate and review opinion by full Court pursuant to Section 7460(b), Internal Revenue Code of 1954, were denied by the Tax Court on March 22, 1956.

/s/ CHARLES K. RICE,      C.A.R.  
Assistant Attorney General;

/s/ JOHN POTTS BARNES, C.A.R.  
Chief Counsel, Internal Revenue Service, Counsel  
for Petitioner on Review.

Filed September 5, 1956. T.C.U.S.

[Title of Court of Appeals and Cause.]

T. C. Docket No. 52071

## STATEMENT OF POINTS

Comes Now the petitioner on review herein and makes this concise statement of points on which he intends to rely on the review herein, to wit:

The Tax Court of the United States erred:

1. In basing its decision on an issue which was not framed by the pleadings, hearings and briefs, and without affording the Commissioner an opportunity to present evidence on the new issue or even to brief it.

2. In holding that the \$2,500 monthly payments in question were compensation for services rendered in the ordinary course of taxpayer's business within the meaning of Section 23(a)(1)(A); that such compensation is not unreasonable; and that therefore the payments in question were deductible by the taxpayer.

3. In failing to uphold the action of the Commissioner that the payments in question represented distributions of profits in the nature of dividends and therefore were not deductible by taxpayer.

4. In holding that the basis for the payments was services rendered by the three payees prior to the execution of the original lease in 1931 and also prior to the execution of the renewal agreement in 1944

and for services to be rendered thereafter during the term of the lease and its renewal.

5. In denying the Commissioner's motion, and amendment to motion, to vacate and review opinion by full Court pursuant to Section 7460(b), Internal Revenue Code of 1954.

6. In holding that there are deficiencies in income tax for 1948 and 1949 in the respective amounts of \$405.43 and \$130.56; and in failing to uphold the deficiencies of \$11,805.43 and \$11,530.56, respectively, as determined by the Commissioner.

7. In that its opinion and decision are contrary to law and regulations and are not supported by its findings of fact or substantial evidence.

/s/ CHARLES K. RICE, C.A.R.  
Assistant Attorney General;

/s/ JOHN POTTS BARNES, C.A.R.  
Chief Counsel, Internal Revenue Service, Counsel  
for Petitioner on Review.

Affidavit of mail attached.

Filed November 14, 1956, T.C.U.S.

In the Tax Court of the United States

Docket No. 52071

MULTNOMAH OPERATING COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

U. S. Court of Appeals Courtroom,

U. S. Court House,

Seattle, Washington,

Friday, June 17, 1955.

Before: Honorable Graydon G. Withey, J. Presiding.

Appearances:

HARRY HENKE, JR., ESQ.,

For the Petitioner.

JOSEPH G. WHITE, JR., ESQ.,

Counsel, Internal Revenue Service,

For the Respondent.

### PROCEEDINGS

The Clerk: Docket Number 52071, Multnomah Operating Company.

Will counsel please state their appearances for the record.

Mr. Henke: Harry Henke, Jr., appearing for the petitioner, Multnomah Operating Company.

In connection with this case, your Honor, I might state that Mr. Harold L. Scott filed this petition and I would like to ask that we be associated with him in connection with this case and we will actually carry on the trial of the action.

The Court: Very well.

Will you state your appearance, Mr. White?

Mr. White: Joseph G. White, Jr., for the respondent. Ready, your Honor.

The Court: Do you have a fact stipulation in this case?

Mr. Henke: We are going to say that we do not. I think, however, in the course of the proceeding we can stipulate most of the items and we will then adjust them.

Mr. White: You have no written stipulations ready?

Mr. Henke: No.

Mr. White: You have no documents to present?

Mr. Henke: Primarily it's documents that we are [3\*] interested in.

Mr. White: I have a rough draft of the various matters that we went over. I do have in the rough draft, though, blank spaces which would call for the information we discussed, like stockholdings and dates and so forth, so perhaps during the noon hour we can go over that together and fill in that and then——

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\*Page numbering appearing at top of page of original Reporter's Transcript of Record.



Mr. Henke (Interrupting): I am sure that can be done, I have the man here with all the figures, so it will be just a question of putting them in the record.

Mr. White: Very well.

The Court: All right, I will hear the opening statement of the petitioner at this time.

Mr. Henke: If your Honor please, this case involves a question of payments which were made in connection with a lease of the hotel in Portland, Oregon, known as the Multnomah Hotel. The record—well, the evidence—will show, that the Multnomah Hotel was owned and is still owned by a corporation in Oregon known as the Hauser Investment Company. In 1931 the property was being operated by the Hauser Investment Company. During the year prior to that time, as a result of rather extended negotiations, they agreed to lease the property to Maltby-Thurston Hotels, Inc., a Washington corporation. Under the terms of that lease, which will be made available in evidence, the property was leased to Maltby-Thurston [4] Hotels, Inc., and there was a provision in the lease that the lease could be transferred to a new corporataion to be organized, a new Oregon corporation, which would actually be the operating corporation for the hotel, the provisions of the lease requiring that any such corporation to have available to it and be able to employ the officers of Maltby-Thurston Hotels, Inc., and a corporation known as Western Hotels, Inc.

In addition to that, at that time there was executed a supplemental agreement separate from the

lease, under the terms of which there was deposited 750 shares of the then preferred stock of Maltby-Thurston Hotels, Inc., having a par value of \$75,000. This separate agreement provided that in the event there was any default on the part of the Multnomah Operating Company or Maltby-Thurston Hotels, Inc., for that matter, if it did not transfer the lease, the 750 shares of preferred stock would go to the Hauser Investment Company by way of liquidated damages by reason of the default. That agreement we have not been able to find a copy of, though the records show, the minutes show the approval of the basic agreement and the deposit of the stock.

At the time of the transfer of the lease from Maltby-Thurston Hotels to Multnomah Operating Company there was an additional agreement on the part of Multnomah Operating Company that it would pay to Maltby-Thurston Hotels, to Peter G. Schmidt as trustee, and to Frank A. Dupar, an overriding [5] rental, which was in the amount of \$30,000 a year, which was paid in monthly installments, but represented total payments of that amount, but of which \$15,000 was payable to Maltby-Thurston Hotels, \$7,500 to Peter G. Schmidt, trustee, and \$7,500 to Frank A. Dupar.

The stock of Multnomah Operating Company, a corporation having a very nominal capital, was owned one half by Maltby-Thurston Hotels, Inc., one-quarter by Pacific Coast Investment Company, which Peter G. Schmidt was actually the president of, and the remaining quarter was owned in varying

degrees by Frank A. Dupar and others who were associated with him, particularly his brother Harold Dupar, now deceased, and two other gentlemen who are also now deceased, and all their perspective shares are now being held by the trustee of their estates.

This overriding rental was paid continuously, as a matter of fact, has been paid continuously to date. The original lease was for a period of 15 years, which would have expired in 1946. Prior to the expiration of that lease there were a, there were extended negotiations with the Hauser Investment Company for the extension of the lease. About approximately two and a half years prior to the expiration of the original lease, in 1944, there was an agreement entered into whereby the original lease was extended for an additional period of 15 years. At the same time and as a part of the [6] same transaction, there was entered into an agreement with Hauser Investment Company where, in lieu of the stock which it previously held, there was deposited 750 shares of the common stock of Maltby-Thurston Hotels, Inc., which stock was now owned by Multnomah Operating Company. That was again deposited under the terms of an agreement where that stock was subject to forfeiture by way of liquidated damages to the Hauser estate in the event the terms of the Multnomah lease were not observed. We do have a copy of that agreement and that will be entered into the record and presumptively it is in substantially the same terms as the original

agreement, with respect to the deposit of that security. As I say, the Multnomah Operating Company at this time owned the stock deposited because the stock previously deposited was stock of Maltby-Thurston Hotels, itself, it having deposited stock by way of security, having an indemnity agreement from Pacific Coast Investment Company, from Frank A. Dupar, with respect to their 25 per cent interest which ultimately was repaid, but which was reimbursed by the Multnomah Operating Company.

Under the terms of this extension, in effect the only change of any consequence made was that the basic minimum rent, which had been established in the original lease, was increased by several thousand dollars. Otherwise, the general provisions were the same and this same overriding lease, this overriding payment, continued to the same parties [7] as in the past. That was paid through to the year, 1948, when, upon audit, the Commissioner challenged the continuance of that payment, claiming that it should be accounted for by Multnomah Operating Company as income and considered as distribution made to its shareholders or to the owners of the corporation. That is a question, of course, which is in issue in this proceeding, is the status of that payment made in 1948 by Multnomah Operating Company to Maltby-Thurston Hotels, Inc., to Peter G. Schmidt, as trustee, and to Frank A. Dupar, Individually. Peter G. Schmidt, as trustee, and according to my understanding, was actually trustee for Pacific Coast Investment Company.

The Court: I will hear from the respondent.



Mr. White: Your Honor, I might add a few remarks by way of opening statement. The years in question are the years 1948 and 1949. The deficiency for each year is approximately \$11,800 or a total of approximately \$23,000. The only question in issue is the sums \$30,000 for each year paid by the petitioner to Maltby-Thurston Hotels, Inc., Peter G. Schmidt of Pacific Coast Investment Company and Frank A. Dupar, which was claimed by the petitioner as a rental expense. The respondent has denied, or disallowed, this deduction, claiming that it is not a true rent but a distribution to shareholders.

Mr. Henke has given some background history of this [8] case, your Honor. The sums of \$30,000 per year were paid to these three entities, it commenced in about the year 1931, and it has continued, as far as respondent knows, through the year 1949. Our disallowance is for the years 1948 and 1949.

We wish to point out to the Court at this time that these, that this payment of \$30,000 was divided amongst these three entities, 50 per cent, 25 per cent and 25 per cent. The 50 per cent was paid to Maltby-Thurston who holds 50 per cent of the stock, 25 per cent was paid to Peter G. Schmidt, trustee of the Pacific Coast Investment Company which holds 25 per cent of the stock of the petitioner, 25 per cent was paid to Mr. Frank A. Dupar. It's our understanding that Mr. Frank A. Dupar, and we thought it was a Mr. Bassett, but we may not be absolutely sure on that, and the evidence will show, to split the stockholding association, but we understood Mr. Dupar and Mr. Bassett, who is now deceased, held

jointly 25 per cent of the stock of the petitioner. In any event, Mr. Dupar, through associations held 25 per cent of the stock of the petitioner and he received 25 per cent of this so-called rental. The respondent wishes to state and it is its contention that there was no consideration for these payments to these three entities. The properties known as the Multnomah Hotel was owned by another corporation, Hauser. The original lease was between Hauser and Maltby-Thurston, Inc. There is no evidence that at the time of this original lease in 1931 [9] the lease had any bonus value or there was any reason why such a high consideration should have been paid for its consignment, nor is there any reason why this so-called rental should have been paid to entities which are not lessees under this original lease. This condition remained until about 1944 when there was a renewal or extension of a lease two years prior to its termination. Again, the same condition arises and the same question, well, why are these sums of money paid to these three individuals? The lessee is Hauser, the lessor is Hauser, the lessee is Maltby-Thurston and at this time Maltby-Thurston has only two years remaining of its lease. Why does the petitioner obligate itself for 15 years to pay this thirty thousand to these three entities? We wish to point out, your Honor, that some question may arise as to, well, what difference does it make to the two corporations, Maltby-Thurston and Pacific Coast, whether they classify this as a dividend or as a rental? If it's a dividend,



they might receive a dividend-paid credit. The first answer to that is that it doesn't apply to Mr. Frank A. Dupar who is an individual. The second answer, that when this was instituted in 1931 there was no such thing, that was not instituted until 1936, so it did make a difference, it made a difference to the petitioner, it receives a deduction if it's rental, no deduction if it is a dividend.

That concludes the respondent's remarks, your Honor, [10] and we are ready to proceed.

The Court: Call your first witness.

Mr. Henke: There are a number of documents to be introduced which possibly we can stipulate into the record now.

Did you have those leases and various documents?

Mr. White: I have returned them to you.

Mr. Henke: Oh!

The first document I ask to be marked for identification is the original lease of June, 1931.

The Clerk: Exhibit 1 for identification.

(Petitioner's Exhibit Number 1 was marked for identification.)

Mr. Henke: I believe you are agreeable that this be stipulated into the record.

Mr. White: So stipulated.

The Court: It will be received.

(Petitioner's Exhibit Number 1 was received in evidence.)

## PETITIONER'S EXHIBIT No. 1

This Indenture of Lease dated the 17th day of June, 1931, by and between Hauser Securities Company, an Oregon corporation, the Lessor, and Maltby-Thurston Hotels, Inc., a Washington corporation, the Lessee,

Witnesseth:

## Article I.

## Grant.

That the Lessor, for and in consideration of the rents, covenants and conditions herein reserved and set forth on the part of said Lessee to be paid, kept and performed, does hereby rent, lease, let and demise unto the Lessee, to Have and to Hold, all the following described real property situate and being in the City of Portland, County of Multnomah and State of Oregon, and more particularly described as:

“All of Lots One (1) to Eight (8), inclusive, Block Forty-four (44), City of Portland, Multnomah County, Oregon, said premises being generally known as Multnomah Hotel of Portland, Oregon;”

also, the furniture, fixtures, equipment and/or personal property contained in said hotel and owned by the Lessor which is maintained in the above described premises, the same being specifically listed in an inventory which is hereby referred to as Exhibit “A” and to which the parties hereto have affixed their signatures for the purpose of identifica-

Petitioner's Exhibit No. 1—(Continued)

tion, which by reference thereto is made a part hereof as though fully incorporated herein, for and during the full term of fifteen years, commencing on the first day of July, 1931, at six o'clock a.m. of said day and ending on the first day of July, 1946, and six o'clock a.m. of said day unless same be sooner terminated as herein provided.

Article II.

Percentage Rental of Gross Revenue.

That during the term of this lease the Lessee agrees to pay unconditionally to the Lessor at such place in the City of Portland, Oregon, as the Lessor may from time to time designate in writing by the way of rental (a) fifteen per cent (15%) of the gross revenue except gross revenue provided for in subsection (b) hereof, from the maintenance, operation, leasing and use of the premises and property herein described and from the subletting, renting and leasing of store rooms or any space in said premises as herein permitted and from the use and operation of said premises as a hotel, including all departments thereof such as rooms, ballrooms, laundry service, telephone service (except such long distance income as is credited wholly and directly to the Telephone Company), concessions, lights to tenants of stores and concessions, tailor shop, miscellaneous and incidental activities and (b) seven per cent (7%) of the gross revenue from the maintenance and operation of restaurant, banquets, cafe-

## Petitioner's Exhibit No. 1—(Continued)

teria, coffee shop, restaurant sundries and income from sale of garbage and bottles. Said payments of 15% and 7%, as above specified, shall be paid during the entire period of this lease; provided, however, that nothing herein contained shall release said Lessee from the payment to Lessor of the minimum fixed monthly rental hereinafter provided for in Article III.

## Article III.

## Minimum Fixed Monthly Rental.

That during the entire term of this lease notwithstanding anything herein contained that might be considered to the contrary, the Lessee agrees to pay to the Lessor unconditionally (except as provided in sub-section (a) of this Article III) by the way of rental for said premises not less than the net sum of Seven Thousand Dollars (\$7,000.00) per month for the period beginning on the first day of July, 1931, at six o'clock a.m. of said day and ending on the first day of July, 1946, at six o'clock a.m. of said day, which rental shall be known as a "minimum fixed monthly rental."

## Article X.

[Lessee agrees to pay taxes, assessments.]

## Article XIV.

[Lessee covenants to protect property by insurance at its own expense.]

Petitioner's Exhibit No. 1—(Continued)

Article XV.

[Lessee agrees to pay for licenses and permits.]

Articles XVI and XVII

[Lessee agrees to keep premises in good repair; Lessee agrees to spend \$21,600.00 per year on maintenance or pay to Lessor any sum short of that.]

Article XXII.

[Lessee agrees to protect Lessor from liability.]

Article XXVIII.

Subleases.

All leases, rental agreements or otherwise, written or verbal, made by said Lessee, pertaining to the premises hereby leased, shall be separate and distinct agreements and set forth specifically the amount of rental (said rental to be a bona fide sum) to be paid for said premises herein demised and said leases, rental agreements or otherwise, shall be inferior and subordinate to the within lease and the same shall so provide \* \* \* It being expressly understood and agreed that the within-named lessor has the exclusive option and right of terminating any such subleases, agreements or occupancies in the event of the cancellation, surrender or termination of the within lease by giving written notice to that effect to said subtenants, lessees or occupants as above stated.



## Petitioner's Exhibit No. 1—(Continued)

## Article XXIX.

## Assignment.

This lease to a large extent is based upon the personnel of the present officers of said Lessee and their ability to conduct and operate a first-class hotel and by reason thereof Lessee covenants and agrees not to assign this lease nor sublet nor underlet nor permit any other person or persons to occupy said premises other than the employees and patrons of said Lessee without the consent of said Lessor being first obtained in writing[, \* \* \* save and except that this inhibition does not prevent the sub-leasing of storerooms on the ground floor of the premises hereby demised and other space therein to organizations or institutions of a character, in the opinion of Lessee, to be advantageous to the operation of said hotel, subject to the conditions of this lease, that said inhibitions shall include any assignment or transfer, underletting or subletting of said premises by operation of law or otherwise, it being specifically understood and agreed that these inhibitions include and comprehend any assignments, transfer, subletting or underletting that might be in any manner accomplished by receivership or attachment or execution or by any other legal or judicial process and any and all voluntary or involuntary assignments of any and every kind and proceedings in bankruptcy]. (Provided further that it is understood and agreed that the within Lessee contem-



## Petitioner's Exhibit No. 1—(Continued)

plates the forming of an Oregon corporation to whom the within lease may be assigned by it, the majority of the personnel of which will be the same as that of the within named Lessee and/or Western Hotels Inc. and Lessor consents to the within named Lessee assigning the within lease to said corporation to be duly formed providing that said assignment shall be subject to all of the terms, covenants and conditions of the within lease and with the consent that the demised premises are only to be used for the purposes herein stated and that the within consent shall in nowise alter, change or modify any term, covenant, provision or condition hereof nor shall this consent be continuing or extended to any other person, firm or corporation; provided further that said assignee shall in a form entirely satisfactory to the within-named Lessor accept said assignment and agree to be bound by all the terms, covenants and conditions of the within lease; that this consent of assignment is limited to the one assignment herein stated, and after such assignment all liability of the within Lessee shall be at an end.)

## Article XXXV.

## Use of Name.

It is further covenanted and agreed that in the event of a forfeiture of the within lease by Lessee, then the Lessor shall have the right to use any name, mark, plan, or publicity scheme adopted by said Lessee as the same may apply to the premises herein demised or any part thereof; provided, however, that the name "Western Hotels" or any symbol

Petitioner's Exhibit No. 1—(Continued)  
thereof, is not included within the purview of this  
Article XXXV.

Article XXXIX.

Successors and Assigns.

It is mutually covenanted and agreed by the parties hereto that all of the expressions, terms, conditions, provisions and agreements shall extend to and be binding upon and inure to the benefit of, as the case may be, the successors and assigns in interest of the Lessor or Lessee; provided, however, that no assignment may be made by the Lessee or by operation of law without the consent of the Lessor, as hereinbefore provided in Article XXIX.

In Witness Whereof, the said Hauser Securities Company, an Oregon corporation, and said Maltby-Thurston Hotels, Inc., have caused this and another instrument of like tenor to be executed in their respective corporate names by their respective officers thereunto duly authorized and the respective corporate seals to be hereto affixed, pursuant to resolution duly and legally adopted by the respective Boards of Directors or Trustees, on the day and year first above written.

HAUSER SECURITIES  
COMPANY,

By /s/ RUPERT V. HAUSER,  
President;

By /s/ A. E. TWEEDDALE,  
Secretary.

Petitioner's Exhibit No. 1—(Continued)

MALTBY-THURSTON  
HOTELS, INC.,

By /s/ S. W. THURSTON,  
President,

By /s/ H. E. MALTBY,  
Secretary.

Admitted in evidence June 17, 1955.

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Mr. Henke: This is a rather extended document and apparently is the only copy we have in the office here and what we propose and I assume that counsel is agreeable to, is to ask leave to withdraw that exhibit and make a copy of those portions which either counsel considers pertinent to the case and substitute that in lieu of the original lease itself. [11]

The Court: I will make a general ruling at this time that either party may, in the absence of any specific objection, remove any original exhibit and substitute a copy.

Mr. Henke: In this particular one, it was our desire to eliminate certain portions of it, in other words, this is one of these rather extended hotel leases which covers damage and fire and so on, which is not pertinent so our thought was we could just copy those portions which counsel respectively want to put in.

Mr. White: So agreed.

Mr. Henke: Will you mark this, Mr. Clerk?

The Clerk: Exhibit 2 for identification.

(Petitioner's Exhibit Number 2 was marked for identification.)

Mr. Henke: This is copies of the original assignment by Maltby-Thurston Hotels to Multnomah Operating Company of the lease of June 17, 1931, together with the acceptance of that assignment by the Hauser Securities Company.

Mr. White: I have no objection to this document, but I want to make these remarks at this time, that the respondent does not stipulate to any consideration in the amount of \$30,000, the sums in question—strike that remark.

The respondent wants to make it clear that its contention that it's not so stipulated, that there was any consideration paid to Multnomah Hotel for \$30,000 which it [12] has agreed to pay these three entities and the respondent is not stipulating that there was any bonding or legal obligation on the part of Multnomah to pay that \$30,000, and we would like to also make clear for the record that we don't intend to foreclose ourselves at this time as to testimony on the part of the Multnomah by the petitioner, explaining the circumstances of this \$30,000 payment. So if that is agreeable with the petitioner, we will stipulate that the document may be introduced in evidence.

Mr. Henke: The document isn't intended to prejudice the position of the Commissioner in any way, it's merely by way of showing the actual

assignment of the lease in accordance with the original terms.

The Court: It may be received.

The Clerk: Exhibit 2.

(Petitioner's Exhibit Number 2 was received in evidence.)

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## PETITIONER'S EXHIBIT No. 2

Portland, Oregon, June 30, 1931.

For One Dollar (\$1.00) and other good and valuable consideration, the undersigned, Maltby-Thurston Hotels, Inc., a Washington corporation, does hereby assign, set over and transfer to Multnomah Operating Co., an Oregon corporation, all of its right, title and interest in and to that certain lease made, executed and delivered on the 17th day of June, 1931, by and between Hauser Securities Company, an Oregon corporation, as lessor and the undersigned, Maltby-Thurston Hotels Inc., a Washington corporation, as lessee, subject to all the terms, covenants and conditions of said lease and with the understanding that the demised premises are only to be used for the purposes in said lease stated and that the consent to this assignment shall in nowise alter, change or modify any term, covenant, provision or condition thereof nor shall the consent to this assignment be continuing or extended to any other person, firm or corporation



Petitioner's Exhibit No. 2—(Continued)  
and with the understanding that said Multnomah  
Operating Co. is bound by all the terms, covenants  
and conditions of said lease.

MALTBY-THURSTON  
HOTELS INC.,

By /s/ S. W. THURSTON,  
President,

By /s/ H. W. CASSON,  
Asst. Secretary.

(Corporate Seal Maltby-Thurston Hotels, Inc.)

For and in consideration of the above assignment  
and for One Dollar (\$1.00) and other good and  
valuable considerations, the undersigned, Mult-  
nomah Operating Co., an Oregon corporation,  
hereby agrees to be bound by and to fully perform  
all the terms, covenants and conditions of the above  
mentioned lease and consent to said assignment.

MULTNOMAH  
OPERATING CO.,

By /s/ S. W. THURSTON,  
President,

By /s/ FRANK A. DUPAR,  
Secretary.

Whereas by Article XXIX, of that certain lease  
made and entered into on the 17th day of June,  
1931, by and between Hauser Securities Company,



Petitioner's Exhibit No. 2—(Continued)

an Oregon corporation, as lessor and Maltby-Thurston Hotels, Inc., a Washington corporation, as lessee, it is provided that said lease should be assigned to a corporation to be duly formed as therein provided and

Whereas the above corporation known as Multnomah Operating Co., an Oregon corporation, has been duly organized in accordance with the terms of said Article in the above mentioned lease, and in pursuance of the provision provided for in said Article, the undersigned, Hauser Securities Company consents to the aforesaid lease being assigned by Maltby-Thurston Hotels, Inc. to Multnomah Operating Co., an Oregon corporation, subject to all the terms, covenants, *providions* and conditions of the within lease.

This consent is given as in said lease provided, that the demised premises are only to be used for the purposes in said lease stated and that the within consent shall in nowise alter, change or modify any term, provision or condition thereof nor shall this consent be continuing or extended to any other person, firm or corporation, and that said Multnomah Operating Co. assumes and is bound by all of the terms of said lease and this consent.

HAUSER SECURITIES  
COMPANY,

By /s/ RUPERT V. HAUSER,  
President,

Petitioner's Exhibit No. 2—(Continued)

By /s/ A. E. TWEEDDALE,  
Secretary.

Dated at Portland, Oregon, this 30th day of June,  
1931.

(Corporate Seal Hauser Sec. Co.)

Admitted in evidence June 17, 1955.

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Mr. Henke: Might we have just one moment?

The Court: We will be off the record.

(Discussion off the record.)

The Court: On the record.

Mr. Henke: Would you mark this, please?

The Clerk: Exhibit 3 for identification.

(Petitioner's Exhibit No. 3 was marked for  
identification.) [13]

Mr. Henke: Exhibit 3 offered for identification  
is the supplemental indenture amending the lease of  
December, 1944, as between the Hauser Securities  
Company and Multnomah Operating, and I believe  
it's agreeable, counsel, that that also be stipulated in  
the record?

Mr. White: It may be received; so stipulated,  
your Honor.

The Court: It may be received.

The Clerk: Exhibit 3.

(Petitioner's Exhibit Number 3 was received  
in evidence.)

PETITIONER'S EXHIBIT No. 3

Supplemental Indenture Amending and  
Extending Lease

This Supplemental Indenture, dated this 4th day of February, 1944, but effective as of February 1, 1944, by and between Hauser Securities Company, an Oregon corporation, the Lessor, and Multnomah Operating Co., an Oregon corporation, the Lessee, for and in consideration of mutual covenants and other valuable considerations passing between the parties, the receipt whereof is hereby acknowledged,

Witnesseth:

Whereas, on the 17th day of June, 1931, an Indenture of Lease was entered into between Hauser Securities Company, an Oregon corporation, and Maltby-Thurston Hotels, Inc., a Washington corporation, upon the real property hereinafter described, the premises thereon being generally known as Multnomah Hotel of Portland, Oregon, together with certain furniture, fixtures and equipment maintained in said hotel premises, reference to which indenture of lease is hereby made and by such reference said lease is made a part hereof; and thereafter on June 30, 1931, for a valuable consideration said lease was assigned and transferred to Multnomah Operating Co., an Oregon corporation, with the understanding that said Multnomah Operating Co. was to be bound by all the terms, covenants and conditions of said lease; and

## Petitioner's Exhibit No. 3—(Continued)

Whereas, said Indenture of Lease would, unless terminated as otherwise provided in the lease or unless extended as herein provided, end on the 1st day of July, 1946, and the parties have agreed upon the terms and conditions upon which said lease shall be amended and that the new terms and conditions thereof shall be effective beginning February 1, 1944, and that said lease as so amended and modified shall be extended and continued in force subject to all the terms and conditions thereof until July 1, 1961;

Now, Therefore, in consideration of the premises and other valuable considerations, it is hereby agreed as follows:

1. That certain Indenture of Lease dated June 17, 1931, by and between Hauser Securities Company, an Oregon corporation, and Maltby-Thurston Hotels, Inc., a Washington corporation, which was assigned to Multnomah Operating Co., by said assignment dated June 30, 1931, and the term thereof, shall be and the same is hereby extended for and during the full term of seventeen years and five months, commencing on the 1st day of February, 1944, at six o'clock a.m. of said day and ending on the 1st day of July, 1961, at six o'clock a.m. of said day, unless the same be sooner terminated as in said lease provided; subject, however, to all the terms, covenants and conditions of said lease and the due, punctual and proper performance thereof by lessee, and subject also to all the terms, covenants and conditions of this Supplemental Indenture and the due, prompt and punctual performance thereof by lessee.

Petitioner's Exhibit No. 3—(Continued)

2. It is understood that the existing lease dated June 17, 1931, would, unless amended, extended or terminated as provided in said lease, end on July 1, 1946, and that one of the considerations for the extension of said lease is the fact that the agreed minimum rental for the extended term and all the terms, conditions and provisions of said lease as extended and amended by this Supplemental Indenture shall be effective and binding from February 1, 1944, and that lessee expressly waives any provisions of said original lease inconsistent with this Supplemental Indenture.

3. Article III of said Indenture of Lease dated June 17, 1931, shall be and the same is hereby amended so as to read as follows:

“Article III.

“Minimum Fixed Monthly Rental.

“That during the entire term of this lease, notwithstanding anything herein contained that might be considered to the contrary, the lessee agrees to pay the lessor unconditionally by the way of rental for said premises not less than the net sum of Eight Thousand Five Hundred Dollars (\$8,500.00) per month for the period beginning on the 1st day of February, 1944, at six o'clock a.m. of said day and ending on the 1st day of July, 1961, at six o'clock a.m. of said day, which rental shall be known as a 'minimum fixed monthly rental.' \* \* \*”



## Petitioner's Exhibit No. 3—(Continued)

10. Article XXIX of said Indenture of Lease dated June 17, 1931, shall be and the same is hereby amended so as to read as follows:

## “Article XXIX.

## “Assignment.

“This lease to a large extent is based upon the personnel of the present officers of said lessee and their ability to conduct and operate a first-class hotel and by reason thereof lessee covenants and agrees not to assign this lease nor sublet nor underlet nor permit any other person or persons to occupy said premises other than the employees and patrons of said lessee without the consent of said lessor being first obtained in writing, save and except that this inhibition does not prevent the subleasing of storerooms on the ground floor of the premises hereby demised and other space therein to organizations or institutions of a character, in the opinion of lessee, to be advantageous to the operation of said hotel, subject to the conditions of this lease, that said inhibitions shall include any assignment or transfer, underletting or subletting of said premises by operation of law or otherwise, it being specifically understood and agreed that these inhibitions include and comprehend any assignment, transfer, subletting or underletting that might be in any manner accomplished by receivership or attachment or execution or by any other legal or judicial process and any and all voluntary or in-



Petitioner's Exhibit No. 3—(Continued)

voluntary assignments of any and every kind and proceedings in bankruptcy.

“Lessee covenants that the majority of the personnel of lessee will continue to be the same as that of Maltby-Thurston Hotels, Inc., and/or Western Hotels, Inc., unless (a) said personnel is changed by death or (b) unless the written consent of lessor to change in personnel is secured. Lessee further covenants that it has secured the consent and agreement of Maltby-Thurston Hotels, Inc., and of Western Hotels, Inc., to the provisions of this Article.”

In Witness Whereof, the said Hauser Securities Company, an Oregon corporation, and said Multnomah Operating Co. have caused this Supplemental Indenture Amending and Extending Lease to be executed in their respective corporate names by their respective officers thereunto duly authorized and the respective corporate seals to be hereto affixed, pursuant to resolution duly and legally adopted by the respective Boards of Directors or Trustees, on the day and year first above written.

(Corporate Seal, Hauser Sec. Co.)

HAUSER SECURITIES  
COMPANY,

By /s/ RUPERT V. HAUSER,  
President;

## Petitioner's Exhibit No. 3—(Continued)

By /s/ A. E. TWEEDDALE,  
Secretary.

(Corporate Seal, Multnomah Operating Co.)

**MULTNOMAH OPERATING  
COMPANY,**

By /s/ S. W. THURSTON,  
President;

By /s/ F. A. DUPAR,  
Secretary.

Admitted in evidence June 17, 1955.

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Mr. Henke: Will you mark this?

The Clerk: Exhibit 4 for identification.

(Petitioner's Exhibit Number 4 was marked  
for identification.)

Mr. Henke: This is a supplemental agreement of February 4, 1944, between Multnomah Operating Company and Hauser Securities Company, whereby Multnomah Operating Company deposited as additional security for the extended lease 750 shares of common stock of Maltby-Thurston Hotels, Inc.

The Court: Is there an objection?

Mr. White: No objection, your Honor.

The Court: It may be received.

The Clerk: Exhibit 4.

(Petitioner's Exhibit Number 4 was received  
in evidence.) [14]

PETITIONER'S EXHIBIT No. 4

This Agreement made and entered into this 4th day of February, 1944, by and between Multnomah Operating Company, an Oregon corporation, herein referred to as Lessee, and Hauser Securities Co., an Oregon corporation, herein referred to as Lessor,

Witnesseth:

Whereas, the said Lessor and Lessee have simultaneously herewith entered into a certain written Supplemental Indenture Amending and Extending Lease of June 17, 1931, covering those certain premises described in said lease and generally known as the Multnomah Hotel in the City of Portland, Oregon, for a term of seventeen years and five months beginning with the 1st day of February, 1944, and ending on the 1st day of July, 1961, all as provided for in said lease, and

Whereas, negotiations between the parties have been under way for a long period of time, and

Whereas, said Lessor has insisted upon the payment of \$50,000.00 in cash as a consideration for the execution of said lease and that Maltby-Thurston Hotels, Inc., a Washington corporation, guaranteed the performance of said lease throughout the entire period of said lease, and

Whereas, said Maltby-Thurston Hotels, Inc., is represented as a corporation having a large financial worth, and

## Petitioner's Exhibit No. 4—(Continued)

Whereas, the parties hereto have reached an agreement as covered by the aforementioned lease,

Now, Therefore, in consideration of the execution of the aforesaid Supplemental Indenture Amending and Extending Lease and the mutual covenants and agreements herein contained to be kept and performed,

It Is Mutually Agreed between the parties hereto:

1. That there is hereby delivered to said Lessor Certificates representing 750 shares of no par value common stock of Maltby-Thurston Hotels, Inc., a Washington corporation, which is fully paid and non-assessable which is delivered and is to be held by said Hauser Securities Company as security and to protect said Lessor in the prompt and due performance of all and every provision, covenant and condition of that certain lease hereinabove referred to as extended and amended by said supplemental indenture.

2. In case of any default, breach, non-observance or non-performance of any of the covenants, terms or conditions contained in said written lease above mentioned as so extended and amended which are to be kept, done, observed and performed on the part of lessee or upon the failure to keep and perform any provision herein contained, and lessor exercises any right or rights given to it under Article XXXVIII of said lease, the said Lessor shall have the right to sell, assign, transfer or dispose of said

Petitioner's Exhibit No. 4—(Continued)

stock or any part thereof and to keep and hold the proceeds arising from the sale, transfer or other disposition of said stock or any part thereof as its own and absolute property without accounting to said lessee for any of the said proceeds and in case of any breach of the conditions as aforesaid, the said Lessor may sell and dispose of said stock at private sale without giving the said Lessee any notice whatsoever of its intention so to dispose of and sell said stock or any part thereof or at the option of said Lessor, it may retain said stock as its own and absolute property and have the same re-issued to it as absolute owner.

3. That until default occurs in said lease or under this agreement, any and all dividends hereunder shall be paid to Hauser Securities Company and by it in turn paid over to said Multnomah Operating Company.

4. While said stock is issued to said Lessor as "pledgee," the said term is not to be construed in the light of the law of pledges or the rights or powers of a pledgee but said stock is to be governed and controlled and subject to all the terms, covenants and conditions hereof as though the word "pledgee" did not appear in said stock certificate. The word "pledgee" shall not in any wise limit, modify or qualify any of the rights hereunder.

5. It Is Expressly Mutually Understood and Agreed that the said Multnomah Hotel owned by said Lessor has reached an enviable position in the Northwest as a hotel and its standing is of the



## Petitioner's Exhibit No. 4—(Continued)

highest order and great loss and damage would be sustained by said Lessor in the event it was necessary to cancel and retake said premises and valuable rights are conferred by the leasing of said premises and in consideration of the waiver of the points and conditions set forth in the preamble of this agreement, it is distinctly understood that the amount of damages which the Lessor may sustain by reason of the breach of said lease and the waiver of the points first hereinabove enumerated cannot be estimated or determined and hence the said stock or proceeds derived therefrom is to be taken as liquidated damages and not as a penalty but is expressly paid as liquidated damages and said Lessee warrants that it will make no claim to the contrary.

6. In the event that said Lessee shall promptly, faithfully and truly keep, do, observe and perform all of the terms, conditions, covenants and agreements of said lease as so amended and extended which are to be kept, done, observed and performed on the part of said Lessee, then upon the termination of said written lease, said Lessor will retransfer and deliver to said Lessee all of said stock above described.

7. This agreement is binding upon the parties hereto, their successors and assigns.

In Witness Whereof, the parties hereto have caused their corporate names to be hereto affixed by their proper officers first duly authorized.

(Corporate Seal, Multnomah Operating Company.)



Petitioner's Exhibit No. 4—(Continued)

(Corporate Seal, Hauser Sec. Co.)

MULTNOMAH OPERATING  
COMPANY,

By /s/ S. W. THURSTON,  
President;

By /s/ F. A. DUPAR,  
Secretary.

HAUSER SECURITIES CO.,

By /s/ RUPERT V. HAUSER,  
President;

By /s/ A. E. TWEEDDALE,  
Secretary.

Admitted in evidence June 17, 1955.

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The Clerk: Exhibit 5 for identification.

(Petitioner's Exhibit Number 5 was marked  
for identification.)

Mr. Henke: This is an agreement of February 3, 1944, between Maltby-Thurston Hotels, Inc.; Western Hotels, and Multnomah Operating Company, in regard to the continued payment of the supplemental rentals which are the subject of the dispute in this case.

Mr. White: I have no objection, your Honor, except for the same qualifications which respondent has stated in reference to Exhibit 2.

The Court: So understood. It may be received.

The Clerk: Exhibit 5.

(Petitioner's Exhibit Number 5 was received  
in evidence.)

## PETITIONER'S EXHIBIT No. 5

## Memorandum of Agreement

This Agreement, entered into this 3rd day of February, 1944, by and between Maltby-Thurston Hotels, Inc., and Western Hotels, Inc., both Washington corporations, hereinafter called "parties of the first part," and Multnomah Operating Co., an Oregon corporation, hereinafter called "party of the second part," in consideration of mutual promises and other valuable consideration, receipt whereof is hereby acknowledged,

Witnesseth:

Whereas, on June 17, 1931, an Indenture of Lease was entered into between Hauser Securities Company, an Oregon corporation, as lessor, and Maltby-Thurston Hotels, Inc., as lessee, covering premises known as Multnomah Hotel, of Portland, Oregon, which lease was negotiated by Maltby-Thurston Hotels, Inc., by and with the participation and assistance of Peter G. Schmidt, Trustee, and Frank A. Dupar; and thereafter said lease was sold, transferred and assigned to Multnomah Operating Co. pursuant to provisions of Article XXIX of said lease, which provided that said lease could be assigned to an Oregon corporation providing the majority of the personnel thereof will be the same as that of Maltby-Thurston Hotels, Inc., and/or Western Hotels, Inc.; and

Whereas, said transfer and assignment to Multnomah Operating Co. was upon certain terms and

Petitioner's Exhibit No. 5—(Continued)

conditions, including the payment of \$2,500.00 to be paid each month for each and every month of the full term of such lease, said payments to be made to Maltby-Thurston Hotels, Inc., \$1,250.00 per month, Peter G. Schmidt, Trustee, \$625.00 per month, and Frank A. Dupar, \$625.00 per month; and

Whereas, said lease, unless otherwise extended, would by its terms terminate on July 1, 1946, and the parties are desirous of securing an extension of said lease and such extension has been negotiated by and with the assistance of Maltby-Thurston Hotels, Inc., Peter G. Schmidt, Trustee, and Frank A. Dupar and such extended lease provides for the minimum rentals to be paid thereunder, in larger amount than previously, and that such rental provisions and other provisions and conditions of the extension are to take effect as of February 1, 1944, rather than to await the expiration of the original term of said lease, all of which has been consented to by Maltby-Thurston Hotels, Inc.; Peter G. Schmidt, Trustee, and Frank A. Dupar, whose payments from Multnomah Operating Co. may be affected thereby; and

Whereas, the parties now desire to define their future rights, duties and obligations with reference to this matter;

Now, Therefore, it is hereby agreed:

1. Maltby-Thurston Hotels, Inc., the party of the

## Petitioner's Exhibit No. 5—(Continued)

first part, hereby consents to the instrument designated "Supplemental Indenture Amending and Extending Lease," to be entered into as of the same date hereof, and further agrees that the payment of the rentals provided for in the amended and extended lease shall be a prior charge and claim which party of the second part is to pay each month before the payment in said month of the monthly payments of party of the second part to Maltby-Thurston Hotels, Inc., Peter G. Schmidt, Trustee, and Frank A. Dupar. To this agreement party of the first part warrants that it has procured or will procure the consent of said Peter G. Schmidt, Trustee, and Frank A. Dupar.

2. Party of the second part agrees that one of the considerations by which it was able to secure the extension and amendment of said lease was the assurance of Maltby-Thurston Hotels, Inc., to Hauser Securities Company, the lessor, that the provisions of Article XXIX of the original lease would be continued in force with respect to the covenant that the majority of the personnel of Multnomah Operating Co. would be the same as that of Maltby-Thurston Hotels, Inc., and/or Western Hotels, Inc. Accordingly, parties of the first part agree that the personnel of the Oregon corporation, to which said lease was assigned, namely, Multnomah Operating Co., will continue to be the same as that of Maltby-Thurston Hotels, Inc., and/or Western Hotels, Inc., unless (a) said personnel is

Petitioner's Exhibit No. 5—(Continued)

changed by death or (b) the consent of the lessor, Hauser Securities Company, is received to the change of personnel.

3. Party of the second part agrees that the extension of said lease has been procured through the efforts of personnel of Maltby-Thurston Hotels, Inc., and of Western Hotels, Inc., with the personal assistance of Frank A. Dupar and S. W. Thurston. In consideration of procuring such extension and in consideration of the other covenants, terms and provisions of this agreement, Multnomah Operating Co. agrees that the monthly payment of \$2500.00 which was the consideration for the assignment of said lease, shall continue to the end of the full extended term. Party of the second part therefore covenants and agrees for the consideration aforesaid to pay for each and every month during the full extended term of said lease the sum of \$1250.00 per month to Maltby-Thurston Hotels, Inc., or its distributees or assigns, \$625.00 per month to Peter G. Schmidt, Trustee, or his assigns, and \$625.00 per month to Frank A. Dupar or his assigns; provided, however, that said payments may by agreement be paid quarterly, semi-annually or annually.

4. It is further understood and agreed that in consideration hereof parties of the first part agree to co-operate with party of the second part in the successful operation of the hotel and to give it such assistance as they properly can, provided that they undertake hereby no obligation to pay any part of



Petitioner's Exhibit No. 5—(Continued)  
the underlying rental or any of the operating expenses of the hotel, and it is further understood that the assistance to be furnished hereunder shall not prevent Western Hotels Inc., from providing management services for said hotel for a consideration, according to previous practice.

In Witness Whereof, the parties hereto have caused this instrument to be executed by their duly authorized officers the day and year in this instrument first above written.

MALTBY-THURSTON  
HOTELS, INC.,

By /s/ S. W. THURSTON,  
President;

By /s/ H. E. MALTBY,  
Secretary.

WESTERN HOTELS, INC.,

By /s/ S. W. THURSTON,  
President;

By /s/ F. A. DUPAR,  
Secretary.

MULTNOMAH OPERATING  
CO.,

By /s/ S. W. THURSTON,  
President;

By /s/ F. A. DUPAR,  
Secretary.



Petitioner's Exhibit No. 5—(Continued)

Approved:

/s/ PETER G. SCHMIDT,

/s/ FRANK A. DUPAR.

Admitted in evidence June 17, 1955.

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Mr. Henke: We will call Mr. Frank A. Dupar.

FRANK A. DUPAR

was called as a witness by and on behalf of the petitioner, and, having been first duly sworn, was examined and testified as follows:

The Clerk: Will you please state your name and address, Mr. Witness?

The Witness: Frank A. Dupar.

Direct Examination

By Mr. Henke: [15]

Q. Will you state your address?

A. 4318 Fifty-Fifth Northeast, Seattle.

Q. Mr. Dupar, referring to the Multnomah Operating Company, what is your relationship to that corporation?

A. I am the president of the corporation at the present time.

Q. Have you always been president of the corporation?

A. No. Mr. Thurston was president for, oh, up until the last three years.

(Testimony of Frank A. Dupar.)

Q. What office did you hold prior to that time?

A. I was secretary.

Q. And were you secretary from the time the corporation was originally formed? A. Yes.

Q. In June of 1931, when the lease of the Multnomah Hotel was organized, can you state what the relationship was between Maltby-Thurston Hotels, Inc., Pacific Coast Investment Company and yourself?

A. We had, about a year before we had organized the Western Hotels, the management company. It was a case of three very bitter competitors trying to live together.

Q. How was the stock of Western Hotels owned?

A. The stock was owned 50 per cent by Maltby-Thurston Hotels, Inc., and 25 per cent by the Pacific Coast Investment Company and 25 per cent by myself. [16]

Q. Now, you said these participants were bitter competitors. Can you explain what you meant by that statement?

A. Well, they had been fighting all over the state. One instance is up in Bellingham, where the P.C.I. interests owned the Leopold Hotel. The Maltby-Thurston interests, along with the Metropolitan Building Company people here, suddenly decided to build a hotel up there, called the Bellingham Hotel. There was a race to see who could get their hotel opened first. Then there was a very bitter battle to see who could stay alive.

(Testimony of Frank A. Dupar.)

Q. In regard to the negotiations for the Multnomah, who carried on those negotiations, that is, this original lease of 1931?

A. Mr. Thurston, Peter Schmidt and myself.

Q. Now, those gentlemen represented which corporation?

A. Mr. Thurston represented Maltby-Thurston Hotels, Inc., and Mr. Schmidt represented the Pacific Coast Investment Company. I just represented myself.

Q. Had all of these three factors, Maltby-Thurston, Pacific and yourself, engaged in the hotel business in this state and general area?

A. Yes.

Q. But always prior to this time upon a competitive basis, is that right?

A. That is correct. [17]

Q. What was the situation of the Multnomah Hotel in 1931 when you were negotiating to obtain possession of it?

A. You mean the physical condition of it?

Q. Yes, the physical condition and the general operating condition of the hotel.

A. It was, we thought, very much run down, their business was slipping away from them—and, you must remember, this was right in the depression, everything was pointed down—and they were apparently losing money in their operation.

Q. What period of time did you negotiate with the Hauser Securities Company with respect to obtaining possession of the hotel, lease of the hotel?

(Testimony of Frank A. Dupar.)

A. I would say it was between ten months and a year.

Q. Was there a substantial amount of time or negligible amount of time involved in these negotiations?

Mr. White: I would object, your Honor. I think that should be pinned down, it should be explained in better terms.

Q. (By Mr. Henke): Will you explain the negotiations, that is, the time involved and so on?

A. We organized the Western Hotels in, well, I believe it was incorporated in September, September 1, 1930. We had negotiated for several months before that. At about that time, about September 1 or possibly before, we had our first meeting [18] with Mr. Hauser, Eric Hauser came up to Seattle, that started it.

Q. How many times would you say you met, how extensive were the negotiations?

A. It would lag for a few weeks and then it would come to life again. I would say that we made 25 trips down there.

Q. How much time did you personally devote to this negotiation?

A. Well, I went down on every trip. We would sometimes be a couple of days.

Q. Now, when the Multnomah Operating Company was organized, how was the stock of that corporation distributed?

A. Maltby-Thurston Hotels, Inc., took 50 per

(Testimony of Frank A. Dupar.)

cent. Peter Schmidt, as a trustee, I believe, took 25 per cent, and out of the 621½ shares left I had 171½ shares, Mr. Bassett had 15 shares, my brother had 15, and a Mr. Belanger had 15.

Q. Are any of the three parties, you have now last named, still living?

A. No. They have all passed away.

Q. What is the status of the stock which they owned? Is that held by trust or what is its status?

A. My brother's stock is held by the First National Bank as trustee for the estate.

Q. In that same amount as was originally issued?

A. Yes. [19]

Mr. Belanger's stock was sold; I bought a part of it and Mr. Bassett bought a part of it.

Q. So that your holdings of the stock are now—how many shares do you own?

A. Twenty-seven and a half shares.

Q. And the Bassett estate owns, holds how many?

A. The Bassett estate holds 20 shares and the bank holds 15 shares.

Q. The beneficiaries of Harold Dupar's estate are who?      A. One daughter, who still lives.

Q. And the Bassett estate?

A. In the Bassett estate there are the widow and four children and a number of grandchildren, I don't know how many.

Q. And the Belanger estate has no interest now at all?      A. No.

Q. Who was the motivating factor in setting up this payment by Multnomah Operating Company



(Testimony of Frank A. Dupar.)

over and above the rentals payable to the Hauser Securities Company?

Mr. White: Your Honor, before he answers the question, could I ask for some explanation about the phrase "motivating factor," just what the question means?

The Court: No.

You may answer.

I think that is fairly clear.

A. I would say that I was the motivating [20] factor.

Q. (By Mr. Henke): What was the basis of your demand for those payments being made?

A. Can I explain that in detail?

The Court: You are asked to explain it.

The Witness: All right.

A. Maltby-Thurston was a holding company and not an operating company. That is why they negotiated for the lease with the stipulation that it be passed to an operating company. Also Maltby-Thurston was in very serious financial trouble, as good corporations were in 1931.

My position was that I had very little of the stock. I was just a minority stockholder. I had done all the work, I was entitled to something, and I hung out for a lease that would pay me something.

The Court: You had done all what work?

The Witness: Negotiating the, negotiating the lease with the Hausers, which took several months.

Q. (By Mr. Henke): The Multnomah Operat-



(Testimony of Frank A. Dupar.)

ing Company had what actual capital when it started business?

A. A thousand dollars, two hundred shares—yes, that is right.

Q. Was there any deposit agreement of any kind with the Hauser Securities Company to secure the performance of [21] the lease?

A. Yes, there was 750 shares of Maltby-Thurston Hotels, Inc.

Q. And how was that deposited? I mean, what was the arrangement under which it was deposited?

The Court: Isn't that a matter of stipulation?

Mr. Henke: The reason I ask that question is that we have been unable to find a copy of the original agreement with Hauser Securities under which this deposit was made, it apparently has been destroyed.

The Court: All right.

A. It's my recollection that it was as a guarantee for the fulfillment of the lease.

Q. (By Mr. Henke): Would you say that its terms were substantially the same as the terms of the agreement entered as Exhibit Number 4 of February 4, 1944? Would you take a look at that agreement and see if that is substantially as the terms upon the original deposit was made?

The Court: Will you state the exhibit number?

Mr. Henke: Exhibit Number 4, your Honor.

The Court: Very well.

A. Yes, that is my recollection of it. It's the same kind of a paper. [22]

(Testimony of Frank A. Dupar.)

Q. (By Mr. Henke): The only difference being that the original was 750 of preferred, of par value at \$100, and this is 750 common?

A. That is right, but in the meantime Maltby-Thurston went through a financial reorganization, the preferred was wiped out, or it was changed into common, I forget the terms whereby it was converted.

Q. Now, this 30,000—this 750 shares of preferred that was deposited in 1931, where did that come from?

A. Maltby-Thurston issued the stock and it was bought by the Multnomah Operating Company.

Q. With respect to that, did you individually give any guarantees to Maltby-Thurston Hotels, Inc.?

A. Yes.

Q. What was the nature of that agreement? What was the nature of your commitment to Maltby-Thurston Hotels, with respect to the stock?

A. As I remember, I gave them a note for it, but I can't tell you right now. I obligated myself for 25 per cent of that \$7,500—or \$75,000.

Q. Now, that was as a guarantor of the obligation of the Multnomah Operating Company?

A. I guaranteed Maltby-Thurston that they would get par for their stock, for the 25 per cent that I assumed, and then sold it to Multnomah Operating and just took an open account for it. [23]

Q. Did you subsequently pay to Maltby-Thurston Hotels upon account of that guarantee?

(Testimony of Frank A. Dupar.)

A. Yes, I did. I gave them stock and notes.

Q. Can you state whether or not you were ultimately reimbursed with respect to that payment?

A. I was reimbursed by the Multnomah Operating Company. That is right.

Q. In connection with this payment which you received from Multnomah Operating Company, which is the item in dispute here, did you share that with your brother, the Bassett estate, and Mr. Belanger?

A. No, that was mine, that was understood to be mine.

Q. And they made no claims whatsoever with respect to it?           A. None whatever.

Q. Were they acquainted with the fact that that payment was being made?           A. Oh, yes.

Q. With respect to Multnomah Operating Company as of 1931, what was your then anticipate of the earning prospects of the company?

A. Well, we really didn't expect to get all our lease rent.

Q. Pardon me?

A. I say, we did not expect to get the \$30,000 even, [24] we didn't think it would make that much.

Q. Why was that?

A. Well, as I say, we were in the depression and it was getting worse every day. Our business was going down, our volume was going down. That continued for, well, right into '32.

Q. Well, what was the condition of the property as to its requirements with respect to maintenance?

(Testimony of Frank A. Dupar.)

A. It was in a very dilapidated condition. The lobby was just shameful, I thought. The rooms upstairs were perhaps 250 without baths. The furniture was old, the carpets were old, it needed a great deal of work, great deal of money spent on it.

Q. What was your assumption at that time as to the disposition which would be made of the earnings of Multnomah Operating Company for some years to come?

A. Well, I felt that everything we made would go back into rehabilitating of the building.

Q. What effect did that have upon your insistence upon receiving compensation for services and negotiating the lease?

A. Well, I needed money as bad as anybody at that time. I felt that if I didn't have some kind of a prior claim I would never get anything out of it. Being a very small minority stockholder, I just felt that anything could happen to Maltby-Thurston; they might lose control; it might just get into [25] a position where somebody else would get the corporation or control of it and manipulate it to their own ends.

Q. Did you consider that your services in connection with the negotiation of that lease justified the payment which was required?

A. Yes, I did.

Q. Did you have in mind any questions of the effect taxwise upon Multnomah Operating Company?

A. Taxes were a very small matter in those days.

(Testimony of Frank A. Dupar.)

I don't remember what the tax rate was, but I don't think it was over ten per cent.

Q. Now, you continued to receive those payments until what time? Or have you continued receiving the payments?

A. We are still receiving them, yes.

Q. What occurred in 1944 with regard to the negotiation of an extension of this lease?

A. We had talked several times about extension of the lease. I think perhaps in 1940 we started to talk to them. And they said it was too soon to begin negotiations. But along in 1944, early in 1944, they were receptive to an extension of the lease, they were satisfied with our operation; we were paying them a good rent; but there was quite a bit of uncertainty at that time. Now, this was in 1944. The war was still on. We had, I think every government expert in the country said we were going to have a terrific depression just [26] as soon as the war was over. That seemed to be the feeling throughout the country. The landlord, while he was getting in excess of the minimum rent, insisted on putting the rent up about \$3,000 a month, the minimum. We were quite disturbed, feeling that when the war was over that we might plunge right back into the hard times again.

Q. During the war years, what was the status of the property from the standpoint of maintenance?

A. We were unable to do anything without a priority. I think that is generally known, that you



(Testimony of Frank A. Dupar.)

couldn't do any new work, you couldn't do any repairs except what were absolutely necessary, and then you had to issue a priority for it.

Q. What was the revenue situation of the property during the war years?

A. The revenue was very high, the net revenue.

Q. Why was that?

A. It was because we run almost a hundred per cent full, wages, prices, everything were controlled, but our volume went up. And naturally, we were not able to spend the money we should have in the maintenance of the property, so naturally, we had a very high earning.

Q. Who negotiated the renewal of the lease in 1944?      A. Mr. Thurston and myself.

Q. Mr. Thurston being the president of Maltby-Thurston, Inc.? [27]      A. That is right.

Q. What was your view as of 1944, at the time this lease was renewed, or extended, as to the future prospects of the property?

A. Well, we felt that we would have to spend a great deal of money on it, that perhaps we would put our earnings in there for a number of years, just put them back into the property. One item was a kitchen which at that time was to cost about \$165,000. Another thing was rehabilitation of the lobby, putting in new dining rooms, refurnishing, redecorating all the rooms upstairs.

The Court: Gentlemen, I would like to know whether or not there has been any effort at all to settle this case, and any talk concerning it?



(Testimony of Frank A. Dupar.)

Mr. White: I haven't been present at any settlement conferences, your Honor. Whether there were any prior to my coming to Seattle, I don't know.

The Court: It's a very strange thing to me if the testimony of Petitioner's other witnesses is going to be the same as that of this witness, even that the issue is as it is between you. It seems to me to be that with a reasonable approach to a situation, the parties could arrive at a settlement easily in this case.

Mr. White: Your Honor, I might add at this time, that I am wondering at the relevance of nine-tenths of Mr. [28] Dupar's testimony.

The Court: I think it's relevant all right, but it's strange to me that, and I will admit that I haven't heard all the testimony, but I have heard the opening statements, it's strange to me that the petitioner takes the position that this is a lease payment and it is somewhat strange to me that the respondent takes the position that it's a corporate dividend payment. I think that there is a clear area in which great profit could be made by both parties in talking settlement in this case.

Mr. Henke: I believe Mr. Scott of Peat, Marwick and Mitchell carried on negotiations for an extended period of time both with the Director's office and with the appellate staff, in an attempt to reach some settlement of this case. I think there has been extensive negotiations in that respect, so far as he is concerned.

(Testimony of Frank A. Dupar.)

The Court: All right, we will proceed with the case, but in view of the fact that there have been some negotiations.

Q. (By Mr. Henke): Mr. Dupar, what are the series, what type of operation does Western Hotels, Inc., engage in?

A. We are a supervision company. We give them, we take care of their books, we look after their statements, we send inspectors around to investigate any discrepancy or any [29] inefficiency. If a hotel falls below certain standards we set, we send a man in to see if he can correct it. We have food experts, we have housekeeping and maintenance experts and so forth.

Q. Western Hotels, Inc., does not operate any properties itself? A. No.

Q. It is purely a management service?

A. Management and supervisory.

Q. Under the terms of this original lease and under the terms of the extension, you were obligated, both Western Hotels, Inc., and Maltby-Thurston Hotels, Inc., to furnish personnel to the Multnomah Hotel? A. That is right.

Q. From your standpoint, did you consider that prejudicial to you in any way with respect to the development of the properties?

A. I don't know as I would—I would figure that was a compliment.

Q. What I meant, under the terms of this extension, would you feel at liberty to employ the services of Western Hotels and the associated com-

(Testimony of Frank A. Dupar.)

panies in the development of other properties in Portland?

A. No. Not without the consent of the Hausers.

Q. Would that be considered a serious concession from [30] your standpoint? A. Yes, it would.

A. Yes, it would.

Q. Will you explain that answer?

A. Eric Hauser, who represented the owners in most of the negotiations, was very particular on the point of who was going to run the hotel. He said as long as the Western, the same personnel as is now in the Western run, own and operate the Multnomah Hotel, he was willing to give us this extension. And I think if we transferred to another corporation that the lease could be validated, or made invalid.

Q. What is the situation at Portland with respect to the possibility of developing additional hotel properties there?

A. There is a man named Corrigan from Dallas who has signed up the merchants around there for a million dollars and has some of the unions to put up two and a half million from their trust funds to build a new hotel, which would just about put the Multnomah out of business.

Q. In 1944, when you made your commitment on the basis of the extended lease, did you feel that you were in any way prejudicing your personal position by continuing the arrangement, that is, that the participants were?

A. We felt that we had, we were signing up

(Testimony of Frank A. Dupar.)

with the Hausers for another 15 years and that we would have to stay with them and not get into negotiations on a new hotel with [31] other people

Q. Would your companies, as such, be interested in developing the new hotel, either with others or on your own account, in Portland? A. No.

Q. In 1944, what were the circumstances under which the agreement was entered into for the payment of this supplemental rental, what negotiations took place with respect to it?

A. Oh, we negotiated with the Hausers several times. They wanted this increased minimum. They feared the end of the war would drop the income down, they felt the same as we did about it, they were just making themselves safe.

Q. What was your position with respect to the supplemental payment, though? What negotiations took place with regard to that, that is, the continuation of the payments?

A. On the lease, on the \$30,000, you mean?

Q. Yes.

A. Well, I felt we were in for some hard times, too, and I felt that if we gave up two and a half years of low, minimum rental, that we were entitled to something for it, we were entitled to gamble on the future.

Q. In other words, the parties receiving the supplemental rental would be——

A. (Interrupting): Would be \$3,000 a month

(Testimony of Frank A. Dupar.)

removed from where they stood at the present time, you see, or stood [32] in 1944.

Q. In other words, if the old lease had run through its entire course, you would have received those two and a half years of payments?

A. That is right.

Q. Then, it was a—with whom was the agreement made, that is, what discussions took place with regard to the continuance of the——

A. (Interrupting): Well, with Eric Hauser.

Q. No, I mean within your—you did not discuss the supplemental rental payment with Eric Hauser, did you?      A. Oh, no.

Q. What negotiations took place with regard to that, within your own group?

A. Well, Thurston and myself were the only ones down there and we——

Q. (Interrupting): You mean, when you negotiated with Mr. Hauser?      A. Yes.

Q. I am talking now about the supplemental rental payment of the \$30,000 a year. What were the determining factors with regard to the continued extension of that for an extension period?

A. I was all out for getting the payment for the next term of the lease if we had to give up the gamble that we had, [33] that is, if we had to give up our new minimum rent, and the new minimum rent went into effect at once. Does that answer you?

Q. Yes. Well, were there any other factors besides giving up the minimum rental which you were considering then?



(Testimony of Frank A. Dupar.)

A. We had to also agree to the Western Hotel's personnel being in the Multnomah Operating Company. In other words, we had to give up any attempt to go out and join in any promotion of a new hotel.

Mr. Henke: I believe that is all. You may take the witness.

Cross-Examination

By Mr. White:

Q. Mr. Dupar, in 1931 when this lease was negotiated and then assigned to Multnomah, you were then fearing that because of the high maintenance that would be necessary the net profits might be low?

A. Yes, indeed I was.

Q. For the Multnomah? A. Yes.

Q. You also feared that Maltby-Thurston and Pacific Coast Investment Company would wish to retain earnings to take care of rehabilitation or other purposes? A. Yes.

Q. And you wished to guarantee yourself, as a minority, [34] that a certain portion of the net profits from Multnomah would reach you year by year?

A. I wouldn't call it "net profits." I would say that I wanted to get something out of it.

Q. In a sense, you wanted a guaranteed dividend, isn't that correct?

A. No, not a dividend.

Q. You wanted a guaranteed sum of money to come from the corporation to you each year?



(Testimony of Frank A. Dupar.)

A. That is right.

Q. And you were in the typical position of a minority who wants distributions from the corporation and you were up against a typical majority which would prefer to plow back, so to speak?

A. There were several other factors. As I mentioned before, the control of Maltby-Thurston and possibly the Pacific Coast Investment Company might go into other hands.

Q. And that might complicate matters a little more?

A. Yes, sir, they might divert the money to some other place.

Q. And one thing more, they might insist on a more stringent policy of plowing back earnings into Multnomah corporation instead of distributing them? A. They might and they might not.

Q. And so one of the considerations you had in mind [35] was a guaranteed distribution to you of Multnomah's net profit?

A. Well, I am not going to call it "net profit," but I wanted something out of it.

Q. Were you a stockholder of Maltby-Thurston in 1931? A. No, sir.

Q. Did you become a stockholder thereafter?

A. Yes.

Q. When was that?

A. I can't tell you. There were small blocks of stock came on the market in the '30's and I bought some at Mr. Thurston's insistence. He wanted me to go in with him and buy up some stock that was

(Testimony of Frank A. Dupar.)

floating.

Q. When you negotiated for the lease in 1931 from Hauser Securities, or whatever was the name of the——

A. (Interrupting): Hauser Securities.

Q. (Continuing): ——was there bargaining at arm's length?

A. There was, there certainly was.

Q. And Hauser did not lease the hotel to you nor to the lessee, Maltby-Thurston, at any less than what it considered to be a fair rental?

A. No, no, I don't think he did.

Q. Referring to the shares which you held in the petitioner prior to the death of Mr. A. P. Bassett, did you hold any shares jointly with him, was there any joint ownership of shares in the petitioner? [36]

A. In the Multnomah?

Q. I am referring to the sixty-two and a half shares representing one-quarter of the total outstanding.

A. I can't answer that. We bought Mr. Belanger's shares from the Everett Trust and Savings Bank, I believe, who were his executors and we bought them over quite an extended period, and myself and my brother and Mr. Bassett were chipping in a little every month to pay for that. Now, I can't remember the date of it, but it was after 1940, because Belanger died in 1939, this was a year or so after the estate had been settled.

Q. So it was before 1944 that you acquired Mr. Belanger's shares?

(Testimony of Frank A. Dupar.)

A. I think so. So that was only joint ownership I had with him.

Q. Who voted the shares held by either yourself or Mr. Bassett or Mr. Belanger?

A. Well, I voted mine.

Q. Who voted Mr. Bassett's shares?

A. My recollection is that he was at some of the meetings. I guess he voted his own.

Q. Did you ever vote as proxy for either Mr. Bassett—

A. (Interrupting): I have voted as proxy.

Q. Maltby-Thurston Hotels, Inc., when it acquired the lease in 1931, it had no intention of operating the Multnomah Hotel? [37]

A. Oh, no.

Q. It was always intended that the new corporation would be formed, to which this hotel lease would be assigned?

A. Maltby-Thurston was a holding company at that time. At that time it was not against the law to be a holding company. But it did not operate anything.

Q. There was some remark about you having done all the work in the negotiations for this original lease in 1931. To clarify the record, would you state whether you received any assistance or whether there was any other work done on behalf of the leases in 1931, were you the sole negotiator?

A. Oh, no. I think I made it clear, Mr. Thurston, Mr. Schmidt and myself generally went down.

(Testimony of Frank A. Dupar.)

Q. Were the labors approximately equal between you three entities?

A. Oh, I think they were.

Q. What was paid into the petitioner for the shares of stock which were issued in 1931?

A. A thousand dollars, as I remember.

Q. By whom?           A. By all of us.

Q. So that a thousand dollars was paid for the total outstanding shares?

A. Of Multnomah Operating?

Q. Yes. [38]           A. That is right.

Q. Mr. Dupar, you explained that you insisted on this sum of money being paid to you, which is referred to here as rents. Can you state why a similar sum was paid to Mr. Peter G. Schmidt as trustee and why a sum twice in amount was paid to Maltby-Thurston?

A. Well, I can't say why. I insisted on mine. It was my recollection they decided to take some, too.

Q. How did they determine the proportions? Weren't the proportions determined by stockholdings?           A. It was in their case, yes.

Q. When the lease was renewed in 1944, what was the condition of the hotel's maintenance or general repair condition as compared to 1931?

A. We had done a great deal of work in the middle '30's. When we got into the war period it was against the law to do any work. You couldn't do any new work. You could only fix up emergency repairs, like a broken pipe or something like that.

(Testimony of Frank A. Dupar.)

But you couldn't buy a lot of carpet or you couldn't put in new bathrooms or anything of that kind.

Q. Now, the hotel was in substantially better repair or shape, as the word is sometimes used, in 1944 than it was in 1931?

A. Yes, it was, in some places. In some places it was. But I think you will find on the record that the City Health [39] Department said we had to have a new kitchen because things were falling apart.

Q. During the, in the year 1944 and during the war years there were substantial earnings retained which could be expended on repairs, isn't that correct?

A. Not during the war years, you couldn't spend any money on repairs, you just paid taxes with it.

Q. Therefore, there was a substantial amount of cash or liquid assets being retained by the petitioner, Multnomah Operating Company?

A. There was some, yes.

Q. And there was in 1944 and the war years no danger that future earnings would have to be plowed back for repairs and maintenance?

A. Oh, yes, there was.

Q. You just stated that you had substantial earnings being accumulated because they couldn't be expended at that time for repairs or maintenance?

A. That is true. We had a better cash position. We had paid some dividends. We had paid a great deal of taxes. When we talk about repairs, we are



(Testimony of Frank A. Dupar.)

talking—or when we talk about rehabilitation, we are talking about putting in new rooms and things like that, new bathrooms and new kitchens. But when we talk about maintenance, we are talking about carpets and sheets and various things of that [40] kind.

Q. Then, it is correct, Mr. Dupar, that the condition existed in 1931, the danger of plowing back earnings for rehabilitation was not existent in 1944 or the war years, up to about 1946, let's say?

A. Well, it could stand a lot of work on it, all right. We had worn out some of the stuff.

Q. You stated that in 1944 you felt that if you were to give up the minimum rental, which you were then paying to Hauser, that you should be compensated in some way? A. Yes.

Q. How does that explain payment to Maltby-Thurston and Peter G. Schmidt, trustee, as rentals?

A. Well, they were in the same position that I was. Maltby-Thurston was part owner of the lease, the sublease.

Q. And this proportion of thirty thousand was again based on stockholdings, is that correct, Mr. Dupar?

A. On Maltby-Thurston and Pacific Coast Investment, but not on mine.

Q. In 1944, Mr. Dupar, were you associated with any other hotel organizations besides Multnomah and Maltby-Thurston? A. Oh, yes.

Q. Would you state to the Court approximately how many organizations you held the stock in? To



(Testimony of Frank A. Dupar.)

clarify this and simplify this, I am not interested in shares held on the [41] major stock exchanges, which might be held merely for investments, like American Telephone & Telegraph.

A. I would just guess about 15 hotels.

Q. And of how many were you an officer?

A. Oh, eight or ten of them.

Q. And in about how many were you a director?

A. Practically all of them.

Q. Did this condition remain the same throughout the years 1948 and 1949?      A. Yes.

The Court: Witness, you are a good witness when you talk, but you let your voice just die right out. I can't hear what you say.

The Witness: Excuse me, I will try to talk louder.

Q. (By Mr. White): How was the amount of \$30,000 determined, Mr. Dupar?

A. I don't remember now.

Q. Well, referring to 1944, how was it determined?

A. It was just a continuation of what we had before.

Q. Was there any bargaining as to what would be a fair so-called super-rental or supplemental rental?

A. Well, sure. We talked it over. We decided that we were entitled to what we had been getting.

Q. Who bargained with Multnomah to determine whether [42] Multnomah should pay a so-called supplemental rental?

(Testimony of Frank A. Dupar.)

A. Well, we talked it over both ways. Of course, we were officers of Multnomah, naturally.

Q. Isn't it true, Mr. Dupar, that you people were talking with yourselves, that Multnomah was owned by you and you were negotiating with yourselves, each of you three individuals held 50 per cent or 25, and you, although you didn't hold entirely 25 per cent, the remaining 25 per cent was held by either you or Mr. Bassett or Mr. Belanger or Mr. Dupar, who was your brother, and there was no arm's length dealing here, you just sat down together and said, "Well, how much are we going to pay, to ourselves"?

A. There was always the possibility we would want to get out of that job down there.

Mr. White: Would you reread the question? I don't think it was answered, your Honor.

The Court: No, it wasn't answered.

The Witness: Well, I don't see how it could be answered very well.

The Court: I was just going to make the same remark the witness did. The question was so complicated and so conditioned that it would be very difficult to make an answer to it.

Mr. White: I will rephrase the question, your Honor. [43]

Q. (By Mr. White): How was it determined that Multnomah, the petitioner, was to pay \$30,000 for the next 15 years? How was the sum of \$30,000 seized upon?

A. \$30,000 was in the old contract. Now, we

(Testimony of Frank A. Dupar.)

were going to extend the contract. We didn't argue about raising it or lowering it. We just extended it.

Q. It was an arbitrary figure, is that correct, Mr. Dupar?      A. I don't think so.

Q. If it had been one hundred thousand in the original lease, you might have continued it for a hundred thousand?      A. That is right.

Q. It didn't take into account the realities of a present situation, any change in net profit, any change in rentals paid to the original lessor?

A. Yes, it did, and it took into consideration of what would happen in 1945 and '6 when the war was over and we lost our big volume of business.

Q. How did it take that into consideration, Mr. Dupar?

A. Because everybody forecast quite a depression after the war.

Q. What did that have to do with paying \$30,000 to yourself and the remaining two stockholders?

A. We were just extending a lease. We could have [44] raised it, I suppose.

The Court: Well, how did you arrive at \$30,000 the first time you entered into this agreement?

A. I don't know. I don't remember.

Q. How did you arrive at the division of the \$30,000 between you?

A. I held out for 25 per cent of it.

Q. Didn't you divide that \$30,000 on the basis of stockholdings?      A. Not exactly, no.

Q. Why not?

A. Because I didn't own 25 per cent of the

(Testimony of Frank A. Dupar.)

you explain why Maltby-Thurston remains as a party to whom 50 per cent of \$30,000 should be paid after 1946?

A. Well, they would remain, they still had the same holdings.

Q. You mean the same stockholdings in Multnomah? [47]

A. Yes. They have always had the same stockholdings.

Mr. White: There are several other matters I think we will cover in a stipulation. If we can't cover those matters in stipulation, the witness may be examined further by the respondent.

The Court: All right.

I think that I am going to take the noon recess at this time until 2 o'clock.

(Whereupon a recess was taken until 2 o'clock p.m.) [48]

The Court: We will proceed with the Multnomah case.

Mr. Henke: We will call Mr. Thurston.

S. W. THURSTON

was called as a witness by and on behalf of the petitioners, and, having been first duly sworn, was examined and testified as follows:

The Clerk: Will you state your name and address, please?

The Witness: S. W. Thurston, New Washington Hotel, Seattle.

Direct Examination

By Mr. Henke:

Q. Where is your residence, Mr. Thurston?

A. Kirkland, Washington.

Q. What is your position with Maltby-Thurston Hotels, Mr. Thurston?      A. President.

Q. How long have you been associated with that company?

A. Since it was inaugurated in 1929.

Q. Were you president of that company in 1931?

A. I was.

Q. Are you acquainted with the circumstances in respect to the negotiations of the lease on the Multnomah Hotel in Portland, Oregon?

A. I am, as far as my memory serves me. That is quite a [49] long ways back.

Q. Can you tell me who negotiated that lease for the lessee, that is, the lease of the Multnomah Hotel with the Hauser Securities Company?

A. There was three of us most active in it, Mr. Dupar, Mr. Peter Schmidt and myself.

Q. How long did those negotiations take?



(Testimony of S. W. Thurston.)

A. Oh, from a year to a year and a half, maybe, at least a year.

Q. How extensive were those negotiations? How frequently did you meet with the representatives of the Hauser Securities Company?

A. We must have had between twenty and thirty meetings, I imagine, contacts, all together.

Q. How long did those meetings take?

A. From the matter of half a day to two or three days at a time.

Q. What was the condition of the Multnomah at the time that lease was negotiated in 1931? What was the physical condition of the property at that time?

A. It was very badly run down and needed a great deal of rehabilitation.

Q. How did it stand, from the standpoint of the traveling public, users of hotels?

A. By virtue of the condition of the property, it wasn't [50] sitting well at all.

Q. Do you know whether or not the property was being operated profitably at that time?

A. My recollection is that it was showing a loss of some seven or eight thousand dollars a month.

Q. In the negotiations with the Hausers, did they lay down any conditions as to personnel which was to operate the hotel for the lessee?

A. Very definitely. We had organized Western Hotels, which had some twenty-odd hotels, had contacts all through the northwest, which would serve as feeders into the Multnomah, and which encour-



(Testimony of S. W. Thurston.)

aged us to take it, because we felt that we could change that loss into a possible profit by virtue of our contacts and our ability to operate, and it was the personnel equation that I think governed the deal, as far as Hauser was concerned.

Q. Did the Hausers make any requirements in that respect?

A. They did, very definitely, and I believe it was written in the lease, if I remember right, that the same personnel must be maintained, and the lease was taken by the Maltby-Thurston Company and transferred into an operating company, and in that operating, or in that assignment was a definite condition that we had to maintain the personnel and the contacts.

Q. Aside from the provisions of the lease itself, was there any requirement for the giving of security to the Hauser Securities Company? [51]

A. There was seventy-five, or seven hundred fifty shares of Maltby-Thurston preferred stock, it was put up by a security that was considered at that time to be worth \$75,000.

Q. That was to be forfeited as liquidated damages in the event this lease was not carried out in accordance with these terms?

A. Correct.

Q. Who put that stock up?

A. Maltby-Thurston, half of it, half of it was put up by interests, Frank Dupar, including himself, the chief interested party, or a quarter, I mean, and a quarter by Peter Schmidt and the Pacific

(Testimony of S. W. Thurston.)

Coast Investment Company in their side of the picture.

Q. The stock was actually put up by your company, was it not, and they in effect guaranteed you against any loss, is that right?

A. Dupar interests and the Schmidt Maltby-Thurston Company against loss of the quarter interest each that they had.

Q. Did they later make good on that guarantee?

A. They did. It was paid.

Q. Then, subsequent to that time all the parties were reimbursed by Multnomah Operating Company?

A. Correct.

Q. Reference has been made to a supplemental payment which was made by Multnomah Operating Company. Can you tell us [52] the circumstances under which that supplemental payment was negotiated in 1931?

A. At the time we took the property it was a highly speculative venture and it was recognized that we would have to spend a great deal of money for rehabilitation and it would be a question of possibly a number of years before any earnings might be obtained from the property, the interested parties took the stand that they would not go into the deal unless there was some assurance of getting some return on it, so that—before all of the money was spent for rehabilitation, and we hit upon the idea of a sublease, or I don't know what you might call it, a sandwich lease or something, to come in between there, so that it would be considered the

(Testimony of S. W. Thurston.)

same as additional rental that had to be paid, and it would have a priority there, or a reasonable priority, at least, so that they would be reasonably assured of something coming out of it before all of the money was spent for the rehabilitation.

Q. Was any particular member of the parties involved particularly anxious that that be done?

A. Yes, very definitely. Mr. Dupar was in there personally and spent a great deal of time in handling the negotiations and recognized the speculation in the deal, and unless there was something along that line done there was no deal.

Q. And, as a result of subsequent negotiations, you agreed upon the formula for the supplemental rental payment, is [53] that correct?

A. Correct.

Q. That was between yourself, Mr. Dupar and Peter G. Schmidt and his brother Adolph, is that right?

A. That is right, his brother Adolph and other members of that family.

Q. Can you state whether or not that payment represented a fair compensation for the services and liability and responsibility which was involved?

A. We felt it did at that time.

Mr. White: That is calling for some opinion here. It ought to be preceded by some detail as to how this witness is qualified to answer that, I think. I have allowed testimony already as to opinion of value, shares of stock valued at \$75,000, but I don't

(Testimony of S. W. Thurston.)

think I can let this go without objection, your Honor.

The Court: I will overrule the objection, he is party to the agreement and party to the negotiations, he is in a position to give an opinion.

You may answer.

A. We felt that it did. We recalled all of the work we had done in it, the speculation that was involved and the work that was staring us in the face in order to make it a successful enterprise; therefore, we felt it was a fair deal. [54]

Q. (By Mr. Henke): Referring to the years immediately preceding the year 1944, what was the situation with respect to the lease and your negotiations with the Hauser Security Company?

A. At that time, or, as a matter of fact, two years prior to that, or five years prior to the expiration of the 1931 lease, we started negotiations for a renewal of the present lease because we had to build a new banquet room into the hotel, we had to renew practically all of our kitchen equipment, and ventilation and one thing and another at a total of some four hundred thousand dollars, in order to support what we felt was the type of a hotel that would keep a new hotel out of Portland. There was a new hotel being threatened, and is today, as a matter of fact, but at the time it was very acute and, unless we could enlarge our banquet rooms and put in a better type of facilities in there, we would have possibly had the new hotel in the next year or two, so we started those negotiations two and a



(Testimony of S. W. Thurston.)

half, or about five years before that. They felt it was too early. We finally wound them up, I think, about two and a half years, between that and three years, before the lease expired.

Q. You negotiated a new extension agreement?

A. And we negotiated this new extension. And they raised our minimum rental and we got together on what we felt was a fair deal from then on and we proceeded to raise the money to put in the improvements and have carried on along the same lines ever since. [55]

Q. In connection with the extension of the lease, there was an extension agreement for the extension of the supplemental payments?

A. Yes, we felt that had been carried on without any contest from anybody and we felt that the work that was ahead of us then, they were just as much entitled to the consideration as they had been in the past, and so we just didn't raise the question any further or go into any discussion as to any modification of it.

The Court: Can you gentlemen here hear the witness?

Mr. Henke: Yes.

The Court: You appear like you can. I can't hear him when he lets his voice go down.

Mr. White: Could the question be reread?

Q. (By Mr. Henke): During the extension period, were you permitted to maintain the same personnel in the Multnomah Operating Company as was required under the original lease?

(Testimony of S. W. Thurston.)

A. That carried on through the extension automatically, as I understand, as I remember.

Q. And that involved having available the management of Maltby-Thurston Hotels, Inc., and Western Hotels, Inc.?

A. Correct.

Q. Now, you made some mention of the possibility of other hotel properties coming into Portland. Did this agreement with [56] the Hausers in effect foreclose your companies from participating in such ventures?

A. It automatically did that, because we did not want to promote a competitive hotel after having made this major investment in the Multnomah that we did.

Mr. White: Could I ask that be reread?

(Question read.)

Mr. Henke: You may take the witness.

### Cross-Examination

By Mr. White:

Q. Mr. Thurston, referring to the thirty thousand dollars in question, isn't it true that it was not a rental?

A. It was not what?

Q. It was not a rental?

A. It was not a rental?

Q. That is correct.

A. I don't know how you would construe it. It was a lease between the Multnomah Operating Company that required that payment. I don't know



(Testimony of S. W. Thurston.)

how you would refer to it unless it would be as a rental.

The Court: Of course, that is a legal conclusion, at any rate.

Mr. White: Very well, your Honor.

Q. (By Mr. White): Mr. Thurston, how many corporations were you associated [57] with in 1944, approximately?

A. How many corporations? Oh, about twenty.

Q. Were you associated with them as a stockholder, how many were you associated with? And I am not referring to a publicly held corporation in which you may hold just as an investment.

A. I have very few stock interests outside of the hotel companies we are interested in.

Q. I am not interested in your General Motors or anything like that, but the corporations in which you have a substantial interest and you are interested in them more than as a receiver of dividends, or something of that sort, your hotel corporations particularly.

A. Probably four or five is all I have an interest in. The Maltby-Thurston Company is my chief interest.

Q. Were you an officer in these companies?

A. Yes, I am an officer in two other companies.

Q. In how many?

A. Two other companies.

Q. In how many are you a director?

A. Fifteen or twenty.

Q. Did this condition remain the same in 1948

(Testimony of S. W. Thurston.)

and 1949?           A. About that, yes.

Q. Was this thirty thousand dollars which is in question here paid every year, commencing with the year 1931 or 1932? [58]

A. My recollection is that it was not paid fully in 1932, it was probably partly paid. I can't recall, times were pretty tough, but it has been paid regularly, I think, ever since, and I think most of it was paid also in the first two or three years. There may have been a few months there. But they were quite insistent that money be coming forth, be forthcoming promptly, and it was.

Q. Was there a net profit earned by the petitioner, Multnomah, every year, commencing with its year of incorporation, which was in '31?

A. I don't believe we paid any dividends for four or five years, of the Multnomah.

Mr. Henke: That wasn't the question.

Will you read the question back?

The Court: You mean the question and answer?

Mr. Henke: I don't think I got the question.

(Question read.)

A. I believe there was a net profit, but it was all spent in the rehabilitation of the properties. I don't think any of the stockholders got any dividends outside of this lease rent for a number of years.

Q. (By Mr. White): Mr. Thurston, how was the thirty thousand dollars determined in 1931?

A. Well, I just can't recall the detail of it,

(Testimony of S. W. Thurston.)

excepting [59] the meeting of all of the interested parties, where we discussed the pros and cons of it, and finally arrived at this figure, providing it was earned, it was recognized, it was highly speculative, that is how it happened, I believe.

Q. Who were the interested parties?

A. There was Mr. Dupar, Mr. Schmidt, several of Mr. Schmidt's associates, and I believe some of Mr. Dupar's associates, who had some minority interest with him, together with myself, and my many, and the associates.

Q. Isn't it correct that the fifty per cent paid to Maltby-Thurston Hotels, Incorporated, and the twenty-five per cent paid to Peter Schmidt as trustee, were based on stockholdings in the petitioner?

A. I don't recall having any agreement to that effect and I don't know that it was to that effect. I believe that it was predicated a great deal upon the services rendered. I know Mr. Dupar and myself and Mr. Schmidt in person rendered a great deal of services in these cases.

Q. Is it contended that the fifty per cent paid to Maltby-Thurston and the twenty-five per cent paid to Peter Schmidt, trustee, was coincidentally proportionate to the stockholdings of those two in the petitioner?

A. Well, I won't argue that with you. The facts are there to show for themselves.

Q. Mr. Thurston, was compensation paid by the

(Testimony of S. W. Thurston.)

petitioner [60] to Mr. Dupar, Mr. Frank Dupar, in 1944, for his services rendered to that corporation?

A. You mean aside from the lease rental?

Q. That is right, sir.

A. I believe there is, there is some salary that was involved.

Q. Do you recall what that was?

A. Three hundred seventy-five dollars a month, I believe.

Q. Was compensation paid to yourself by the petitioner in 1944 as an officer of that corporation?

A. Yes.

Q. Do you recall what that was?

A. Eight hundred fifty dollars a month is my recollection.

Q. Was compensation paid to Mr. F. M. Kenny as an officer of that corporation in 1944?

A. I cannot recall.

Q. Were there other officers of the petitioner, Multnomah Operating Company, in 1944?

A. Were there other officers, did you say?

Q. That is right.

A. I believe Mr. Kenny was the vice president or a director, I do not recall just which.

Q. Do you know if all officers were paid compensation in 1944 by the petitioner?

A. No, I don't believe there were all officers paid. I [61] believe that Mr. Dupar and myself were paid.

Q. Did you and Mr. Dupar, did either of you

(Testimony of S. W. Thurston.)

work full time for the petitioner, Multnomah Operating Company?

A. We don't work full time for any of them excepting when we are called upon and have work to be done, why, then we work night and day.

Q. Is it not true, then, that you did not render any more services for the petitioner in 1944 than you did for any of your other corporations, your hotel corporations?

A. It depends upon what work had to be done, going through that negotiation of the extension of the lease, going through the additional remodeling and so forth, we put in a great deal of time there.

Q. Does that answer apply to both yourself and Mr. Dupar?           A. It does.

Q. Mr. Thurston, there is some question at the present whether the parties, that is, Mr. Henke and myself, will have a certain document, which is the Western Hotel's Agreement with Multnomah for services rendered.           A. Yes.

Q. So, in view of the fact that it may not be available, could you tell us what the nature of this agreement was, the year in which it was entered into, and how much money was paid to Western Hotels pursuant to this agreement?

A. My recollection is that Western Hotels started in there [62] at five hundred dollars a month, which lasted for a year or two maybe, or something like that, was subsequently raised to one thousand dollars a month, and now carries about one per cent of the gross receipts, which is con-



(Testimony of S. W. Thurston.)

sistent with other properties that are being handled, and that amounts to possibly a little more than one per cent, or a thousand dollars a month.

Q. When did the percentage basis begin, what year?      A. I think it was just last year.

Q. When did the one thousand dollars begin, which year?      A. I can't recall.

Q. Was it before or after——

A. Oh, it was seven or eight years ago, something like that, it may be longer.

Q. Do you know if it was before or after 1944?

A. I can't recall.

Q. Do you know if it was——

A. The records are available for it.

Q. Just, we don't want to bother you too much, but we are not sure we will have the records in time, so this will be a quick way. When was this agreement first entered into?

A. Just about the time we took over the property for Western, because it was the property of Western and Maltby-Thurston that had to operate, and the agreement was then entered into.

Q. Would you explain, to make sure we understand, what [63] the nature of this agreement was? What was Western Hotels to do?

A. It was to handle, it was to supervise the operation of the property, it was to give the benefit of purchases, we buy in volumes and so forth, by virtue of the number of hotels we had, it got the benefit of all that purchase advantage that we had, it had the forwarding business from all of the vari-



(Testimony of S. W. Thurston.)

ous communities that we were interested in, that business was forwarded into the Multnomah, by virtue of our contact in Portland, and the advantages of selecting personnel is quite an advantage because we had such a big organization that we could supply personnel to a much better advantage than an individual operator, and all of the various advantages of that nature, that Western had to supply.

Q. In your negotiations with Mr. Dupar with reference to the Multnomah Operating Company, did Mr. Dupar insist that he would be recompensed in some way, that he would obtain a portion of the profits each year?

A. Correct, before all of the money was spent for rehabilitation, I distinctly remember that was his concern, he knew that we were taking these properties as a rule and spending everything it earned for rehabilitation and therefore the stockholder was possibly out indefinitely and that was one of the chief reasons for this sublease.

Q. Were you a stockholder in Western Hotels, Mr. Thurston? [64]

A. Maltby-Thurston Hotels is a stockholder in Western Hotels. I am not a stockholder. I am an officer of them.

Q. You are an officer in both corporations?

A. Correct.

Q. As such an officer, did you feel that Western Hotels was being adequately compensated for the

(Testimony of S. W. Thurston.)

services rendered during the year 1944 and the years thereafter?

A. Well, it possibly could be a question, but it was all kind of in the family group and we never raised the question of detail, whether it was exact to the cent or not.

Mr. White: That is all I have.

No further questions, your Honor.

The Court: Any redirect?

Mr. Henke: No, your Honor. I believe that is all.

The Court: You may step down.

(Witness excused.) [65]

Mr. Henke: We had one more witness, Mr. Peter G. Schmidt. Mr. Schmidt, however, was scheduled to arrive here from New York tonight by plane, we are contemplating that he would be able to testify tomorrow morning. However, I believe his testimony would be largely a repetition of the testimony of Mr. Thurston. I don't know whether counsel particularly desires his testimony or not.

Mr. White: We had Mr. Schmidt under subpoena, but we won't insist upon his appearance. We are satisfied with the testimony presented so far.

Mr. Henke: Then, the only other matter we would have, your Honor, is the question of completing these items of information which counsel desired to have put into the record.

The Court: Are you able to do that now?

Mr. White: Your Honor, what I would suggest is that we could hold the record open so as to be able to submit that stipulation.

The Court: Yes. The only difficulty with that is that when I hold a—is that when I hold a record open I like to designate exactly for what purpose.

Mr. White: Just to stipulate certain matters as to stockholdings. I could go over it in some detail, I have a rough draft of the stipulation, but I think it might take a little time. Perhaps to preserve the rights [66] of both parties, I ought to go down the line, it will take about five minutes to read or——

The Court: You list what you expect to stipulate.

Mr. White: Before I do that, I would like to list the 1948 and 1949 returns of the petitioners.

Mr. Henke: We have no objection to either return being filed.

Mr. White: I list the 1948 return as Respondent's Exhibit A, your Honor.

The Clerk: Exhibit A.

(Respondent's Exhibit A was marked for identification.)

The Court: It will be received.

(Respondent's Exhibit A was received in evidence.)

Mr. White: Respondent introduces the 1949 return of the petitioner as Exhibit B.

(Respondent's Exhibit B was marked for identification.)

The Court: It may be received.

The Clerk: Exhibit B.

(Respondent's Exhibit B was received in evidence.)

The Court: You may now proceed.

Mr. White: The parties plan to stipulate and it [67] is anticipated they will stipulate the total stock outstanding of Maltby-Thurston Hotels, Incorporated, and show the percentage of shares held at the date of the incorporation of the petitioner, the date of the assignment of the lease in question, which occurred in 1931, at the date of the renewal of this lease in 1944, and during the years 1948 and 1949.

Mr. Henke: In regard to that first item, Mr. White, since this corporation was incorporated in 1931——

Mr. White: The date of incorporation will be satisfactory.

Mr. Henke: The date of incorporation will be satisfactory for both those items.

Mr. White: Very well.

The Court: So understood.

Mr. White: In so doing, we are not stating we ask the petitioner to submit the percentage held by every single stockholder but the percentage held by the major stockholders.

The Court: He could want to do the same with the total stock held by Western Hotels, Incorporated, at these particular dates.

Mr. Henke: I believe you have the testimony of

Mr. Dupar that there has never been any change in the stock, that the stockholdings have been continuously identical. [68]

The Court: If so, it could be simply stipulated that the stockholdings are as such and have never been changed.

Mr. White: We would want the stipulation as to the total outstanding stock of the Pacific Coast Investment Company, showing the total outstanding and the percentage held at the critical dates by the major stockholders.

The next stipulation will be the 30,560 shares of Maltby-Thurston Hotels, Incorporated, which is held in a voting trust. We would like to show who the trustee was, who held the shares of stock which we will list as follows: 1,703 shares, 2,573 shares, 5,510 shares and 2,000 shares, and 7,022 $\frac{3}{4}$  shares. We would like to have the name of the individual who holds those shares and we would like to know whether he holds any capacity as stockholder, director, officer or employee in either Maltby-Thurston Hotels, Incorporated, the petitioner; Western Hotels, Incorporated, or Pacific Coast Investment Company.

Mr. Henke: In regard to that item, your Honor, we are agreeable to furnishing the information. However, I am advised by the auditor that the figures quoted are erroneous.

Mr. White: We will submit the correct figures. What I am interested in is the amount of shares held by Mr. Frank A. Dupar, the amount held by



the T. E. Himmelman, Mr. H. E. Maltby, Mr. T. W. Metzdorf, and Mr. S. W. Thurston. [69]

The next paragraph, your Honor, I propose to stipulate that no consideration was paid by Maltby-Thurston Hotels, Incorporated, for the lease referred to in this proceeding as Exhibit 1, except the consideration stated therein.

The following stipulation would be the rentals paid to Hauser Securities Company by the petitioner since the period of time when the lease was entered into.

Mr. Henke: I am confused as to this——

Mr. White: We have been trying to establish 14, which I read as being no consideration paid by Maltby-Thurston to the lessor other than was stated in the lease. I want to establish whether or not any bonus or sum of money or consideration moved from Maltby-Thurston, the lessor, in addition to what is set forth in the lease agreement. Sometimes there are such things as a bonus payment, as you know——

Mr. Henke: The witnesses have already testified that there were 750 shares of preferred stock of Multnomah which was deposited as collateral.

Mr. White: I see.

Mr. Henke: So I would assume that that was necessarily at least a consideration to the Hauser Securities.

Mr. White: Then my stipulation will go to the matter of that 75,000 shares plus what is set forth in the lease, was there anything in addition paid to the lessor, Hauser Securities. [70]



The Reporter: You said "75,000 shares," Mr. White.

Mr. Henke: Seven hundred fifty shares, seventy-five thousand par value there.

Mr. White: I would like to have a stipulation as to the officers of Maltby-Thurston Hotels, Incorporated, during the period of 1944 to 1949 and the compensation paid to them by the corporation.

I would like to stipulate who are the directors of Maltby-Thurston Hotels, Incorporated, during the period 1944 through 1949.

I would like to stipulate who were the officers and directors of the petitioner during that same period 1948 through 1949 and also in the year 1931 when it was incorporated.

We would like to stipulate who were the officers and directors of Western Hotels, Incorporated, during the period 1944 through 1949.

We would like to stipulate who were the officers and directors of the Pacific Coast Investment Company during the period 1944 through 1949.

That is all, your Honor.

Mr. Henke: There is one additional matter which—pardon me.

The Court: Well, so far I note that it at least in one respect requests, a request is made for a stipulation to [71] a conclusion rather than a fact. It is fine with me if parties can stipulate to conclusions, and the conclusion I am referring to is the matter of consideration referred to.

Mr. White: I would like to clarify that, your Honor. What I was trying to determine was

whether the Maltby-Thurston Hotels, Incorporated, paid any bonus, as it is sometimes called, to the——

The Court (Interrupting): Yes, I understood your position all right. I will make an order that the parties stipulate to the matters just indicated, insofar as they may, with respect—well, absolutely with respect—to the facts insofar as they may with respect to the conclusions that he referred to, and I will hold the record open. How long do you think it would take you to get this together?

Mr. Henke: Mr. Weston, how long do you think it would take to gather that material?

Mr. Weston: Possibly next Wednesday.

The Court: I will hold the record open for 30 days for receipt of written stipulations in Washington.

Now, as I understand the situation at the present time, the petitioner has rested?

Mr. Henke: We have one more, just one item that I did want to put in the record before resting, and that is the minutes of the meeting, first meeting of the board of directors of Multnomah Operating Company as of June 30, 1931, which [72] sets forth the provisions with respect to this supplemental payment. I think you read these. Is that agreeable?

Mr. White: I haven't, but it is all right.

The Court: Is there any objection?

Mr. White: No objection, your Honor.

The Court: I assume you wish to substitute copies?

Mr. Henke: Yes, your Honor.

The Court: All right, the exhibit will be received and permission is granted to substitute a copy.

Mr. White: I think you gave a blanket order which would cover my—respondent's—exhibits?

The Court: Yes, I did, I gave a blanket order.

The Clerk: This will be Exhibit 6.

(Petitioner's Exhibit No. 6 was marked for identification and received in evidence.)

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### PETITIONER'S EXHIBIT No. 6

#### First Meeting of Board of Directors of Multnomah Operating Company

The first meeting of the Board of Directors of the Multnomah Operating Company was held at 617 Corbett Building, Portland, Oregon, on June 30, 1931, at the hour of 4:30 p.m., there being present directors, S. W. Thurston, Eric V. Hauser, and John R. Latourette, all of whom had qualified as directors by taking the oath of office as required by law.

Upon motion duly made, seconded and unanimously adopted, director Thurston was chosen chairman of the meeting.

The chairman announced that the board proceed with the election of officers, whereupon the following proceedings were had:

S. W. Thurston was unanimously elected to the office of President of the corporation.

## Petitioner's Exhibit No. 6—(Continued)

Eric V. Hauser was unanimously elected to the office of Vice President of the corporation.

Frank A. Dupar was unanimously elected to the office of Secretary of the corporation.

Peter G. Schmidt was unanimously elected to the office of Treasurer of the corporation.

H. E. Maltby was unanimously elected to the office as Assistant Secretary.

A proposed seal was submitted, an imprint of which follows, and upon motion duly made, seconded and adopted said proposed seal was unanimously adopted as the seal of the corporation.

The following resolution was proposed, seconded and unanimously adopted, to wit:

“Resolved, That the United States National Bank of Portland, Oregon, and the First National Bank of Portland, Oregon, be the depositaries for the funds of the corporation.”

The following resolution was proposed, seconded and unanimously adopted, to wit:

“Resolved, that checks on the company's bankers shall be signed by either of the following named officers, to wit: S. W. Thurston, President; Frank A. Dupar, Secretary; Peter G. Schmidt, Treasurer, or H. E. Maltby, Assistant Secretary.

“Be It Further Resolved, that in addition to the above-named officers, checks on the United States National Bank of Portland, Oregon, may be signed by Earl McInnes, Resident Manager.

Petitioner's Exhibit No. 6—(Continued)

“Be It Further Resolved, that said Resident Manager is hereby authorized to endorse all checks, drafts, and orders payable to or belonging to this corporation for deposit only.”

The following resolution was proposed, seconded and unanimously adopted, to wit:

“Resolved, that the price of the non-par stock of the corporation be fixed at \$4.00 per share, and upon payment of such price by the subscribers thereto the said stock to be issued fully paid.”

The President submitted to the board a proposal from Maltby-Thurston Hotels, Inc., offering to transfer to the corporation the lease upon the Multnomah Hotel, as follows:

“Portland, Oregon, June 30th, 1931.

Multnomah Operating Company,  
An Oregon Corporation,  
Portland, Oregon.

The undersigned, Maltby-Thurston Hotels, Inc., has carried on for a period of over six months negotiations with the Hauser Securities Company for a lease on the Multnomah Hotel property in Portland, Oregon, which negotiations necessitated the exercise of much knowledge and skill and the expenditure of a considerable amount of time and money. As a result thereof, on the . . . . . day of June, 1931, a lease of said hotel property was entered into between the Hauser Securities Company,



Petitioner's Exhibit No. 6—(Continued)  
the lessor, and Maltby-Thurston Hotels, Inc., the lessee, an original copy of which lease accompanies this offer.

As collateral security for the faithful performance of the terms of said lease Maltby-Thurston Hotels, Inc., deposited with the lessor its preferred stock at the par value of \$75,000.00, in accordance with the terms of a copy of said collateral agreement herewith submitted.

The Maltby-Thurston Hotels, Inc., now offers to transfer and assign all its right, title and interest in and to said lease to the Multnomah Operating Co., an Oregon corporation, upon the following terms and conditions and for the following considerations:

(1) The Multnomah Operating Company shall pay the sum of \$2500.00 per month for each and every month during the full term of said lease, such monthly payments to be made to the following named in the following proportions, to wit:

Maltby-Thurston Hotels, Inc. ....	\$1250.00
Peter G. Schmidt, Trustee .....	625.00
Frank A. Dupar .....	625.00

(2) The Multnomah Operating Company shall purchase on open account the preferred stock deposited as collateral security for said lease for the sum of \$75,000.00, the par value thereof.

(3) The Multnomah Operating Co. shall accept said assignment and agree to be bound by and to



Petitioner's Exhibit No. 6—(Continued)  
fully perform all the terms, covenants and conditions of said lease and consent to said assignment.

(4) Before said assignment shall become effective, it must receive the written consent of the Hauser Securities Company, in accordance with the terms of said lease.

MALTBY-THURSTON  
HOTELS, INC.;

By S. W. THURSTON,  
President."

Whereupon, the following resolution was proposed, seconded and unanimously adopted, to wit:

"Whereas, Maltby - Thurston Hotels, Inc., has offered to transfer and assign to the corporation that certain lease on the Multnomah Hotel, in accordance with the terms of that written offer on file with the corporation and made a part of the minutes hereof, and

Whereas, the Board finds that said offer is a fair and reasonable offer and should be accepted in the interests of the Multnomah Operating Company, Now, Therefore,

Be It Resolved, that the offer of Maltby-Thurston Hotels, Inc., be and the same is hereby accepted, and the officers of this corporation hereby are authorized to accept the transfer of said lease in accordance with the terms of said offer, and to do and perform all acts and things on behalf of this

Petitioner's Exhibit No. 6—(Continued)  
corporation necessary or proper to complete said transfer and observance of all the terms of said offer.”

The following resolution was proposed, seconded and unanimously adopted, to wit:

“Whereas, S. W. Thurston, President; Frank A. Dupar, Secretary, and Peter G. Schmidt, Treasurer, will be required to give much of their time to the affairs of the corporation, and

Whereas, the success of the business is mainly dependent upon the services performed and to be performed by the above-named officers, Now, Therefore,

Be It Resolved, that the monthly salaries of the above-named officers be fixed in the amounts set opposite their respective names, to wit:

S. W. Thurston, President .....	\$750.00
Peter G. Schmidt, Treasurer.....	375.00
Frank A. Dupar, Secretary.....	375.00”

The president requested John R. Latourette, attorney for the company, to prepare a set of bylaws, to be submitted to the board at an early date.

There being no further business to come before the meeting, upon motion the meeting adjourned.

/s/ S. W. THURSTON,  
President;

/s/ FRANK A. DUPAR,  
Secretary;

Petitioner's Exhibit No. 6—(Continued)

JOHN LATOURETTE,  
Secretary of Meeting;

/s/ ERIC O. HAUSER, JR.,  
Director.

Admitted in evidence June 17, 1955.

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Mr. Henke: With that, petitioner will rest, your Honor.

Mr. White: Respondent rests.

Filed July 1, 1955, T.C.U.S. [73]

[Title of Tax Court and Cause.]

### Certificate

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 18, inclusive, constitute and are all of the original papers on file in my office as called for by the "Designation of Contents of Record on Review," and the "Designation of Additional Portions of Record," including petitioner's Exhibits 1 through 6, admitted in evidence, and respondent's Exhibits A and B, admitted in evidence, in the case before the Tax Court of the United States docketed at the above number and in which the respondent in the Tax Court has

initiated an appeal as above numbered and entitled, together with a true copy of the docket entries in said Tax Court case, as the same appear in the official docket book in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 20th day of November, 1956.

[Seal]      /s/ HOWARD P. LOCKE,  
Clerk, Tax Court of the  
United States.

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[Endorsed]: No. 15370. United States Court of Appeals for the Ninth Circuit. Commissioner of Internal Revenue, Petitioner, vs. Multnomah Operating Company, Respondent. Transcript of the Record. Petition to Review a Decision of the Tax Court of the United States.

Filed November 27, 1956.

                  /s/ PAUL P. O'BRIEN,  
Clerk of the United States Court of Appeals for  
the Ninth Circuit.

No. 15370

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**In the United States Court of Appeals  
for the Ninth Circuit**

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

MULTNOMAH OPERATING COMPANY, RESPONDENT

---

*ON PETITION FOR REVIEW OF THE DECISION OF THE TAX  
COURT OF THE UNITED STATES*

---

**BRIEF FOR THE PETITIONER**

---

CHARLES K. RICE,  
*Assistant Attorney General.*

ROBERT N. ANDERSON,  
S. DEE HANSON,  
*Attorneys,  
Department of Justice,  
Washington 25, D. C.*

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**FILED**

**APR - 5 1957**

**PAUL P. O'BRIEN, CLERK**





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**In the United States Court of Appeals  
for the Ninth Circuit**

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No. 15,370

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

MULTNOMAH OPERATING COMPANY, RESPONDENT

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*ON PETITION FOR REVIEW OF THE DECISION OF THE TAX  
COURT OF THE UNITED STATES*

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**BRIEF FOR THE PETITIONER**

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**OPINION BELOW**

The memorandum findings of fact and opinion of the Tax Court (R. 25-48) are not officially reported.

**JURISDICTION**

The Commissioner's petition for review involves deficiencies in income taxes determined and asserted against the taxpayer in the sums of \$11,805.43 and \$11,530.56, aggregating \$23,335.99, for the taxable years 1948-1949 (R. 8-12, 25), and redetermined by the Tax Court in the sums of \$405.43 and \$130.56, aggregating \$535.99, for those years, respectively (R. 54). On December 15, 1953, the Commissioner mailed a statutory notice of such deficiencies to the taxpayer. (R.

8-12.) Within ninety days and on March 3, 1954, the taxpayer, pursuant to Section 272 of the Internal Revenue Code of 1939, filed a petition in the Tax Court for a redetermination of those deficiencies. (R. 3, 5-12.) On February 23, 1956, the Tax Court filed its memorandum findings of fact and opinion (R. 4, 25-48), and on March 21, 1956, the Commissioner filed a motion and also an amendment thereto to vacate and review the Tax Court's opinion by the full Court, both of which were denied on March 22, 1956 (R. 4, 49-53). The decision of the Tax Court was entered on June 14, 1956. (R. 54.)<sup>1</sup> On September 5, 1956, the Commissioner filed a petition for review invoking the jurisdiction of this Court under Section 7482 of the Internal Revenue Code of 1954. (R. 4, 55-56.)

#### QUESTIONS PRESENTED

1. Whether the Tax Court improperly decided the case on a ground not in issue and in respect of which the Commissioner was given no opportunity to present evidence or argument.

2. Whether the monthly and/or quarterly payments made by the taxpayer to its three controlling stockholders, under an agreement entered into contemporaneously with a lease-extension agreement obtained in 1944 by the taxpayer, represented deductible compensation for services rendered by them during the taxable years involved, within the meaning of Section 23(a) (1)(A) of the Internal Revenue Code of 1939, as held by the Tax Court, or distributions in the nature of

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<sup>1</sup> The docket entries indicate that the decision was entered on June 13, 1956. (R. 4.)

guaranteed annual dividends to such stockholders in proportion to their stockholdings in the taxpayer, as determined and contended by the Commissioner.

3. If the payments in question actually represented compensation for services rendered by the controlling stockholders during the taxable years, whether they are shown by the record to have constituted reasonable compensation allowable as deductions under the statute.

#### STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

#### SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses*.—

##### (1) *Trade or Business Expenses*.

(A) *In General*.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; \* \* \* and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. \* \* \*

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(26 U.S.C. 1952 ed., Sec. 23.)

## SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term “dividend” when used in this chapter \* \* \* means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. \* \* \*

(26 U.S.C. 1952 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(a)-6. *Compensation for Personal Services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the



case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. \* \* \*

\*                      \*                      \*                      \*                      \*

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

#### STATEMENT

The facts as found by the Tax Court (R. 25-45), including the stipulated facts (R. 14-24) which were found and adopted by the Tax Court as stipulated (R. 25), may be summarized and restated sufficiently for present purposes substantially as follows:

The taxpayer, Multnomah Operating Company, is a corporation with its principal office and place of business in Seattle, Washington. It filed income tax returns for the calendar years 1948 and 1949 with the collector for the district of Washington. (R. 25.)

The taxpayer was incorporated in 1931 with a paid-in capital of \$1,000 which was represented by 250 shares

of common stock.<sup>2</sup> (R. 25.) On July 1, 1931, the taxpayer's stock was owned 50% by Maltby-Thurston Hotels, Inc. (hereafter called the Maltby), 25% by the Pacific Coast Investment Company (hereafter called PCI), and the remaining 25% was owned 7% by Frank A. Dupar and 18% by others who were apparently associated with him. (R. 26.)<sup>3</sup>

During the period 1944 through 1949 the voting control of taxpayer rested in the members of a voting trust, the identity and stock contributions to the trust of such members being as follows (R. 26):

Multnomah Operating Co.

Members of Voting Trust from May 1, 1940, to  
May 1, 1950

	1944	1948	1949
F. A. Dupar.....	17	17	17
H. E. Dupar.....	15	—	—
Maltby-Thurston Hotels, Inc..	124	124	124
Pacific Coast Investment Co...	61½	61½	61½
Seattle First National Bank, Trustee under Will of H. E. Dupar, deceased .....	—	15	15
	=====	=====	=====
Total.....	217½	217½	217½
	=====	=====	=====

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<sup>2</sup> These shares were held on July 1, 1931, and January, 1944, 1948 and 1949 by the several shareholders as listed in the Tax Court's findings of fact (R. 25-26), and therefore such holdings are not duplicated here.

<sup>3</sup> The Tax Court found that Frank A. Dupar owned 17 shares, H. E. Dupar (his brother) owned 15 shares, and A. F. Bassett and A. D. Berlanger each owned 15 shares. (R. 26, 100-101.) The record shows, moreover, that Frank A. Dupar had joint ownership in Berlanger's 15 shares and had acted as proxy for Bassett's 15 shares. (R. 116-117.)

The Multnomah voting trust stock was votable by S. W. Thurston, Frank Dupar and F. M. Kenney on behalf of PCI in that order conditioned upon whether he who had the primary right so to do died, became incapacitated, unwilling or unable to vote the stock. The Maltby voting trustees in 1948 and 1949 were H. E. Maltby, S. W. Thurston, T. E. Himmelman, Frank A. Dupar and F. M. Kenney. (R. 40.)

Western Hotels, Inc. (hereinafter called Western), was incorporated about 1930 as a hotel service organization rendering general services to all hotels for a consideration. Its total capital stock during 1931 consisted of 5,630 shares, which was reduced to 100 shares in 1934, and on July 1, 1931, and January 1944, and 1948 and 1949, was owned 50% by Maltby, 25% by PCI, and 25% by Frank A. Dupar. (R. 28-29, 98.)<sup>4</sup> The organization of Western represented an effort on the part of Maltby, PCI and Frank A. Dupar, who had previously been competitors, to thereafter cease competition and act in concert to their mutual benefit in the hotel business. (R. 28.)

By a lease, dated June 17, 1931, negotiated at arm's length, Hauser Securities Company leased the Mult-

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<sup>4</sup> This is not apparent from the Tax Court's findings (R. 28-29) or the stipulation of facts (R. 15), in both of which stock ownership in Western is listed. However, the listed stockholders other than Maltby, PCI or Frank A. Dupar apparently represented the stock ownership of those three for Frank A. Dupar testified (R. 98) that Western's stock was owned 50% by Maltby, 25% by PCI, and 25% by himself. All the shareholders of Western as of July 1, 1931, and January 1944, 1948 and 1949, are listed in the Tax Court's findings (R. 29), as they are for PCI as of those dates (R. 29-33); hence, they are not reprinted here. Also, the officers and directors of Western and PCI, as well as of the taxpayer and Maltby, for all times material are listed in the Tax Court's findings (R. 33-40), as stipulated by the parties (R. 18-23), and therefore they are not repeated here.

nomah Hotel in Portland, Oregon, to Maltby for a term of 15 years commencing July 1, 1931, and ending July 1, 1946. The lease (Ex. 1, R. 68-77) provided, among other things, as follows (R. 40-41):

This lease to a large extent is based upon the personnel of the present officers of said Lessee [Maltby] and their ability to conduct and operate a first-class hotel and by reason thereof Lessee covenants and agrees not to assign this lease nor sublet nor underlet nor permit any other person or persons to occupy said premises other than the employees and patrons of said Lessee without the consent of said Lessor being first obtained in writing. \* \* \* (Provided further that it is understood and agreed that the within Lessee contemplates the forming of an Oregon corporation [the taxpayer] to whom the within lease may be assigned by it, the majority of the personnel of which will be the same as that of the within named Lessee and/or Western Hotels, Inc., and Lessor consents to the within named Lessee assigning the within lease to said corporation to be duly formed providing that said assignment shall be subject to all of the terms, covenants and conditions of the within lease and with the consent that the demised premises are only to be used for the purposes herein stated and that the within consent shall in nowise alter, change or modify any term, covenant, provision or condition hereof nor shall this consent be continuing or extended to any other person, firm or corporation; provided further that said assignee shall in a form entirely satisfactory to the within named Lessor

accept said assignment and agree to be bound by all the terms, covenants and conditions of the within lease; that this consent of assignment is limited to the one assignment herein stated, and after such assignment all liability of the within Lessee shall be at an end.

The lease rental consisted of a minimum fixed monthly rental of \$7,000 per month and a designated percentage of gross revenue. No bonus or consideration other than this rental was paid to the lessor. (R. 40.)

The lessor required the deposit of security for the performance by taxpayer of the lease provisions. To that end Maltby issued to taxpayer \$75,000 of its preferred stock which taxpayer agreed to purchase. The taxpayer in turn deposited the stock as security with the lessor. PCI, through its trustee, Peter G. Schmidt, and Frank Dupar each guaranteed to Maltby in writing that taxpayer would pay the par value of 25% of such stock. Each was required at an undisclosed time to pay the amount so guaranteed for which payment each was subsequently reimbursed by taxpayer. (R. 41-42.)

On June 30, 1931, Maltby assigned its interests as lessee to taxpayer, such assignment being assented to by the lessor.<sup>5</sup> The assignment was therein stated to be "For One Dollar (\$1.00) and other good and valuable consideration." (R. 42.)

The lease had been in negotiation for a period of approximately 10 months prior to its execution on June

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<sup>5</sup> The record shows that Maltby was at all times material a holding company and was never intended to operate the hotel; it was always intended by the parties that the new corporation, the taxpayer, would be the operating company. (R. 102, 117.)



17, 1931. The negotiators had been Dupar, Peter Schmidt and S. W. Thurston, who met with Hauser for negotiation approximately 20 times. At the time of assignment of the lease to taxpayer on June 30, 1931, Frank A. Dupar insisted upon compensation for his services rendered in the negotiations for the lease, for his guarantee of payment of par value of 25% of the Maltby stock placed with the lessor as security by taxpayer, and for what he alleged was his interest in the lease. It was agreed between Maltby, PCI and Dupar that taxpayer would pay to them for the assignment of the lease of the hotel premises the amount of \$2,500 per month, or \$30,000 a year, after payment of the fixed and percentage rentals required by the lease terms. Of this amount, Dupar insisted that he receive \$625 per month, or \$7,500 a year, as such compensation. The remainder (\$1,875 a month, or \$22,500 annually), it was agreed, would be divided between PCI and Maltby in proportion to their respective stockholdings in taxpayer. These payments were provided for by a separate written agreement between taxpayer and Maltby entered into simultaneously with the assignment of the lease. Except for an undisclosed but short period of time immediately following inception, these payments have been made throughout the term of the lease and the extension thereof. (R. 42-43.)

At the time the lease was executed the Multnomah Hotel was in bad repair, and it was apparent that large expenditures would be required in order to make it a profitable business asset. To that end the lease required the expenditure by taxpayer of \$21,600 per year over and above all other amounts or that such portion of that amount not so spent be paid to the lessor. (R. 43.)



The original lease terminated by its provisions on July 1, 1946, but an extension was sought by taxpayer as early as 1940 when it became apparent that negotiations by others were in progress in Portland looking toward the construction of a new hotel. Without the expenditure of about \$400,000 for reequipment, remodeling and redecorating, taxpayer's hotel could not withstand the competition of a new hotel. Before making such an investment therefore, taxpayer desired an extension of its lease. Negotiations for the taxpayer's lease extension were carried on by S. W. Thurston and Dupar, Schmidt having taken no part therein. Ultimately an extension agreement (Ex. 3, R. 81-86) was executed directly between taxpayer and the owner of the hotel property. This agreement, dated February 4, 1944, extended the term of the original lease to July 1, 1961, and provided for an increase of the minimum fixed rental to \$8,500 per month. (R. 83.) All of the terms and conditions of the original lease remained in full force and effect under the extension agreement, including the provision that the officers and personnel of taxpayer were to be the same as Maltby or Western. Simultaneously taxpayer and Hauser entered into a separate written agreement (Ex. 4, R. 87-91) whereby provision was made for replacement of the original security of \$75,000 of Maltby preferred stock with a like amount of the common stock of that corporation, which was to be forfeited to Hauser as liquidated damages in case of taxpayer's default in the lease terms. This was stock purchased and owned by taxpayer. (R. 43-44.)

By an agreement between Maltby and Western, as first parties, and taxpayer as second party, dated Feb-

ruary 3, 1944 (Ex. 5, R. 92-97), the taxpayer agreed to continue the payments to Frank Dupar, Maltby and PCI at the rate of \$625, \$1,250 and \$625 a month, respectively, aggregating \$30,000 annually, throughout the extended term of taxpayer's lease to July 1, 1961, inclusive. The consideration therein stated for such extension of the payments was the agreement of those payees to accede to the lease extension at a higher minimum rental before the expiration of the original lease, the agreement of Maltby that its officers and personnel or that of Western would continue to operate the Multnomah Hotel, and the services of Maltby, Western and Frank Dupar in securing through negotiation the lease extension agreement. Peter G. Schmidt, as trustee of PCI, did not in fact aid in the procurement of the extension agreement. However, he and Dupar each approved the last mentioned agreement by their signatures. (R. 44-45.)

On the basis of these facts, the Tax Court, rejecting the Commissioner's determination (R. 8-12) and ignoring the only issue—that the payments in question were deductible under Section 23(a)(1)(A) of the 1939 Code “for rent paid” during the taxable years—as pleaded and argued by the taxpayer (R. 6-7, 45), held that the payments were not “rentals” (R. 46); rather, on its own initiative, it held them to be deductible as “compensation for services rendered [by the taxpayer's three controlling stockholders] in the ordinary course of petitioner's business within the meaning of section 23(a)(1)(A)” (R. 47-48). In view of this inconsistency, a motion to vacate and review the Tax Court's opinion by the full Court pursuant to Section 7460(b) of the Internal Revenue Code of 1954, and an amendment

thereto, were timely filed by the Commissioner, both of which were denied by the Tax Court forthwith. (R. 49-53.) The Tax Court thereupon entered its decision in favor of the taxpayer accordingly (R. 54), from which the Commissioner petitioned this Court for review (R. 55).

#### STATEMENT OF POINTS TO BE URGED

The Tax Court erred (R. 57-58)—

1. In basing its decision on an issue which was not framed by the pleadings, hearings and briefs, and without affording the Commissioner an opportunity to present evidence on the new issue or even to brief it.

2. In holding that the \$2,500 monthly payments in question were compensation for services rendered in the ordinary course of taxpayer's business within the meaning of Section 23 (a)(1)(A); that such compensation is not unreasonable; and that therefore the payments in question were deductible by the taxpayer.

3. In failing to uphold the determination of the Commissioner that the payments in question represented distributions of profits in the nature of dividends and therefore were not deductible by taxpayer.

4. In holding that the basis for the payments was services rendered by the three payees prior to the execution of the original lease in 1931 and also prior to the execution of the renewal agreement in 1944 and for services to be rendered thereafter during the term of the lease and its renewal.

5. In denying the Commissioner's motion, and amendment to motion, to vacate and review opinion by full Court pursuant to Section 7460(b), Internal Revenue Code of 1954.

6. In holding that there are deficiencies in income tax for 1948 and 1949 in the respective amounts of \$405.43 and \$130.56; and in failing to uphold the deficiencies of \$11,805.43 and \$11,530.56, respectively, as determined by the Commissioner.

7. In that its opinion and decision are contrary to law and Regulations and are not supported by its findings of fact or substantial evidence.

#### SUMMARY OF ARGUMENT

1. The Tax Court, on its own initiative, decided this case on the basis of a new issue injected by it which was neither pleaded nor argued by the taxpayer, and in respect of which the Commissioner, taken by surprise, was afforded no opportunity to present evidence and argument. The Tax Court therefore erred in denying the Commissioner's motion, and amendment thereto, to vacate and review its opinion by the full Court, and thereby precluding the Commissioner's presenting evidence on the newly-injected issue. Moreover, since the Tax Court's decision is unsupported by the evidence and therefore is clearly erroneous, it should be reversed by this Court in favor of the Commissioner upon the present record which supports the Commissioner's position taken in the Tax Court. If, however, this Court should not agree with our view that the evidence of record is thus conclusive, we submit that the case should, at a minimum and in any event, be remanded to the Tax Court for the taking of additional evidence on the compensation issue as injected in the case by that tribunal, and particularly as to the reasonableness or not of the compensation.

2. The evidence of record shows that the payments

in question in reality constituted guaranteed distributions in the nature of annual dividends to the taxpayer's three controlling stockholder-payees in proportion to their stockholdings in the taxpayer during the taxable years involved, as contended by the Commissioner in the Tax Court. The payments were made pursuant to the payment agreements of 1931 and 1944 between the taxpayer and one of its controlling stockholders, Maltby, and were payable thereunder monthly and/or quarterly to the three controlling stockholders in proportion to their stockholdings in the taxpayer (except in the case of Frank Dupar if his and not his associates' holdings are only to be taken into consideration). The evidence specifically shows that Dupar insisted upon receiving a guaranteed sum of money to come to him from the taxpayer each year, and therefore the other two controlling stockholders likewise decided to take annual sums from the taxpayer in proportion to their stockholdings. This arrangement was thereupon given effect by them and each thereafter received his or its payments from the taxpayer monthly and/or quarterly accordingly. The authorities cited hereinafter hold that such distributions of corporate earnings and profits constitute dividends — particularly to stockholder-distributees wholly controlling the corporation, as here—whether or not the formalities of a dividend declaration have been observed, the distributions are recorded on the corporation's books or made in proportion to the stockholdings, or some of the stockholders do not participate in the resulting benefits.

Nor did the payments in question in fact constitute compensation for services actually rendered by the



taxpayer's controlling stockholder-payees — Maltby (represented by Thurston), PCI (represented by Schmidt), and Frank A. Dupar (representing himself)—during the taxable years involved. The record shows that, contrary to the Tax Court's holding, controlling stockholder-payee PCI (represented by Schmidt) rendered no services in the negotiations conducted by Thurston and Dupar in arriving at the lease extension agreement of 1944, as the Tax Court itself found. It also shows that the above-mentioned payees or their officers and representatives received regular annual salaries from the taxpayer for their services during the life of the original lease of 1931 and its renewal in 1944. Nor does the record contain any corporate resolutions of the taxpayer providing for the payments in question as additional compensation for services of the stockholder-payees, over and above their or their officers' and representatives' regular salaries received annually from the taxpayer. Further, there is no evidence to show or even to indicate that such regular salaries were not adequate to compensate the payees for whatever services they actually performed for the taxpayer in connection with the operation of the hotel. In any event, the evidence clearly shows that the disputed payments were determined and made in proportion to the payees' stockholdings in the taxpayer, as already shown, and hence there is no basis in this record for the Tax Court's holding that the payments constituted deductible allowances for compensation for services, instead of nondeductible distributions of profits as determined and contended in the Tax Court by the Commissioner.



3. Assuming that the payments in question constituted compensation, as held by the Tax Court, they are nevertheless not shown by the record to have constituted *reasonable* compensation as they must be in order to be deductible under the pertinent statute. The Tax Court's holding to the contrary is not supported by the evidence or record, substantial or otherwise, and is therefore clearly erroneous and should properly be reversed upon review by this Court. The record shows that one-fourth of the taxpayer's annual payments in question was made to one stockholder-corporation which concededly rendered no services to the taxpayer, as the Tax Court itself found; one-half of each annual payment was paid to another stockholder-corporation whose only claim to rendering services to the taxpayer was through its president who, at the same time, was the president of the taxpayer from which he regularly received an annual salary; and finally the remaining one-fourth of such payments was paid annually to Frank Dupar who was the secretary of the taxpayer and likewise receiving an annual salary from the latter during the taxable years involved as well as back to 1931. There is no showing in this record of what would constitute a reasonable allowance for compensation for alleged services rendered by the stockholder-payees, a matter which can be determined only on the basis of a showing of the particular services actually rendered by them. The Tax Court did not specify, nor does the record disclose, the precise nature of the alleged services rendered to the taxpayer by each of the controlling stockholder-payees for which the payments in question allegedly constituted compensation. Accordingly, there

is no basis in this record for the Tax Court's gratuitous holding that the payments in question constituted even compensation for services, much less a "not unreasonable" compensation within the meaning of and deductible under the applicable statute and Regulations, as erroneously held by the Tax Court.

#### ARGUMENT

### I

#### **The Tax Court Improperly Decided the Case on a Ground Not in Issue and on Which the Commissioner Was Given No Opportunity to Present Evidence or Argument**

The sole issue injected and decided by the Tax Court in this case was not pleaded, raised or argued by the taxpayer below, as the Tax Court pointed out and conceded (R. 45-46), nor indeed was the Commissioner afforded any opportunity in the Tax Court to present evidence or argument in respect thereto (R. 49-53).

Briefly, as already pointed out, the taxpayer whose stock was owned 50% by Maltby, 25% by PCI, and 25% by Frank A. Dupar and his associates, was organized in 1931 to become the operating company for the Multomah Hotel, Portland, Oregon, which was leased in that year to Maltby (with PCI and Frank Dupar as interested parties) which in turn assigned the lease to the taxpayer in that year. The Multnomah Hotel, thus leased by the taxpayer, was to be serviced by Western, a hotel service organization whose stock was also owned 50% by Maltby, 25% by PCI, and 25% by Frank A. Dupar. ~~At the time of the execution~~ 25% by Frank A. Dupar. ~~At the time of the execution~~ of the original hotel lease in 1931 and again in 1944

when the taxpayer entered into the lease-extension agreement directly with the lessor, a separate agreement was executed under which the taxpayer was to make payments to Maltby, PCI and Dupar totaling \$2,500 a month, or \$30,000 a year.<sup>6</sup> (R. 92-96.)

The question here presented is as to the deductibility from the taxpayer's gross income of the sum of \$30,000 which was paid annually by the taxpayer to its three controlling stockholders during each of the taxable years 1948-1949. In the Tax Court, the only issue pleaded, argued and briefed by the parties was whether these payments represented "rentals" deductible as business expense, under the provisions of Section 23(a)(1)(A) of the Internal Revenue Code of 1939, *supra*, as contended by the taxpayer (R. 6-7, 45-46), or whether they in reality constituted non-deductible distributions of profits in the nature of guaranteed dividends to the three controlling stockholders of the taxpayer, as determined and contended in the Tax Court by the Commissioner (R. 46). As to this question, the Tax Court, overruling the Commissioner's determination and holding that the payments in question did not constitute rentals as claimed

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<sup>6</sup> At the time of the lease extension agreement made in 1944 and during the taxable years 1948-1949, Thurston was the president and a member of the board of directors of the taxpayer, Maltby and Western; Frank A. Dupar was the secretary and a member of the board of directors of the taxpayer, vice-president and a member of the board of directors of Maltby, and the secretary and a member of the board of directors of Western. (R. 33-38.) Thurston and Dupar each received annual compensation from the taxpayer (R. 19-20) and from Western (R. 21-22), but not from Maltby (R. 18-19). As officers of the taxpayer, Thurston (president) received \$10,200 a year during the period 1944-1949, and Dupar (secretary) received \$4,500 a year during the same period. (R. 19-20.)

by the taxpayer (R. 45-46),<sup>7</sup> thereupon proceeded on its own initiative to consider the payments anew and, as indicated above, without affording the Commissioner any opportunity to present evidence or argument thereon and/or without solicitation on the part of the taxpayer, held that regardless of whatever name the taxpayer called the amounts sought to be deducted, "they were compensation for services rendered in the ordinary course of petitioner's business within the meaning of Section 23(a)(1)(A)," that "such compensation is not unreasonable," and therefore it is deductible by the taxpayer for the taxable years involved under that section of the statute (R. 47-48). In these circumstances, the Commissioner, taken by surprise and in the absence of any opportunity to present evidence or arguments in respect of this new issue thus injected for the first time in the case by the Tax Court, filed a motion to vacate and review the Tax Court's decision by the full court, under the provisions of Section 7460(b) of the Internal Revenue Code of 1954, and also an amendment thereto, on the grounds, among other things, that the decision is in conflict with numerous other decisions of the Tax Court wherein it had refused to consider issues not raised by the pleadings, both of which, motion and amendment, were denied by the Tax Court without giving reasons therefor. (R. 49-53.)

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<sup>7</sup> The Tax Court so held "even though so designated [as rentals by the parties themselves] in written contracts between the three [controlling stockholder] payees and petitioner" (R. 46, 69, 70, 83, 94, 96), and even though the taxpayer itself sought to limit the issue to the sole question as to whether or not the payments in question were properly deductible for the taxable years involved "as rentals" within the meaning of Section 23(a)(1)(A) of the 1939 Code (R. 45-46).



In the light of the foregoing, we submit that the Tax Court's action in deciding the case on a ground newly-raised by itself but neither pleaded, contended for nor argued by the taxpayer was not only most unusual, but also—in failing to give the Commissioner an opportunity to meet the newly-injected issue with evidence and argument—was erroneous as a matter of law, if indeed not arbitrary and capricious. See *Standard Galvanizing Co. v. Commissioner*, 202 F. 2d 736 (C.A. 7th), where the court in a comparable situation stated (p. 739):

This question of negligence on the part of Brightly was not even suggested in the pleadings before the Tax Court, nor was there any stipulation of facts warranting such a finding. \* \* \* We may assume that had the question of negligence been raised in the pleadings before the Tax Court there would have been evidence by which the question could have been accurately determined. In the absence of such an issue in the pleadings and of evidence on the issue, it was error for the Tax Court to raise the question \* \* \*.

To the same effect, see the Tax Court's own decisions as cited by the Commissioner (R. 50) in his motion to vacate and review opinion by the full court and amendment thereto (R. 49-53).

In any event, we submit (and will establish below) that the record fails to support the Tax Court's conclusion (R. 47-48) that the taxpayer's payments to its three controlling stockholder-payees during the taxable years involved constituted compensation for services rendered by them and that the amounts thereof were "reasonable" as required in order to be deductible

under the provisions of Section 23(a)(1)(A); that the evidence fully supports a reversal of the Tax Court's decision as being unsupported by the record and therefore clearly erroneous, and that a remand to the Tax Court should therefore not be necessary. If, however, this court should not agree with our view that the evidence of record is thus conclusive, we submit that, under the above procedural argument, the case should be remanded to the Tax Court for the taking of additional evidence on the compensation issue as injected by that tribunal, and particularly as to the reasonableness of the compensation. In such event, the compensation issue should, we respectfully submit, be directed by this Court to be decided by that tribunal upon remand only after the Commissioner shall have had full opportunity to present evidence, arguments and authorities on the issue—something the Tax Court summarily denied the Commissioner, taken by surprise, at the hearing of the case. (R. 49-53.)

As to our contention that the evidence of record supports a reversal of the Tax Court's decision to the end that a remand to the Tax Court should not be deemed necessary, we submit the following in respect of the new issue involving compensation and the reasonableness or not thereof.

## II

**The Payments in Question Did Not Constitute Compensation for Services Rendered by the Taxpayer's Three Controlling Stockholders During the Taxable Years Involved, But Were in Reality Distributions in the Nature of Guaranteed Annual Dividends to Such Stockholders in Proportion to Their Stockholdings in the Taxpayer**

We submit that (a) the Tax Court's conclusion that the disputed payments made by the taxpayer to its three



controlling stockholders during the taxable years involved represented compensation for services actually rendered by them during those years within the meaning of Section 23(a)(1)(A) is not supported by the evidence and is therefore clearly erroneous, and (b) such payments in reality constituted nothing more or less than distributions in the nature of guaranteed annual dividends to such stockholders in proportion to their stockholdings in the taxpayer corporation.

It will be noted that the Tax Court concluded, on the basis of its findings, that none of these various transactions—except the original lease of 1931 and the renewal thereof in 1944, as negotiated by the three (only two with respect to the 1944 renewal) stockholder-payees who controlled the taxpayer through a voting trust arrangement (R. 26)—here involved was arrived at on an arm's length basis, and therefore each must be closely scrutinized as to whether the disputed payments constituted "other payments required to be made as a condition to the continued use or possession" of the hotel premises, within the meaning of Section 23(a)(1)(A) of the 1939 Code. Upon so doing, the Tax Court arrived at the conclusion that regardless of whatever the taxpayer called the payments in question, they were nevertheless compensation for services rendered by the payees in the ordinary course of the taxpayer's business during the taxable years involved, within the meaning of that Section (R. 47-48). So scrutinizing the same transactions referred to by the Tax Court, however, we fail to find any substantial evidence in this record—and the Tax Court pointed out substantially none (R. 46-48)—to support its conclusion thus arrived at. Rather, substantially all the evidence of record clearly points to the conclusion that the payments in question

constituted distributions in the nature of guaranteed annual dividends to the taxpayer's three controlling stockholders<sup>8</sup> in proportion to their stockholdings in the taxpayer, as contended by the Commissioner (R. 46). Hence, we take up the latter point first.

*A. The payments in question constituted distributions in the nature of guaranteed annual dividends to the taxpayer's three controlling stockholders in proportion to their stockholdings in the taxpayer.*

The record shows, significantly, that the payments made during the taxable years under the second payment agreement dated February 3, 1944 (R. 92, Ex. 5) were made pursuant to an agreement between the taxpayer and one of its controlling stockholders, Maltby, represented by Thurston, and were payable, as under the previous agreement of 1931 (R. 42-43), in the total sum of \$2,500 a month (\$30,000 annually) at the rate of 50% to Maltby, and 25% to each PCI and Dupar (R. 44, 92-97). Moreover, in 1944, when the second payment agreement was executed (R. 44), the taxpayer's stock was owned, through a voting trust, 50% by Maltby, 25% by PCI, and 25% by Dupar and his brother (R. 26). Under the voting trust, the taxpayer's stock was votable by Thurston (president of the taxpayer and also of both Maltby and Western) (R. 18-21), Dupar (secretary of the taxpayer and Western and also vice-president of Maltby) (R. 18-21), and F. M. Kenney (vice-president of the taxpayer and Western and also president of PCI) (R. 18-21) in be-

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<sup>8</sup> The taxpayer's three controlling stockholders referred to were Maltby (represented by Thurston) and PCI (represented by P. G. Schmidt), and the individual stockholder, F. A. Dupar, representing himself (R. 46).

half of PCI, in that order (R. 40).<sup>9</sup> In these circumstances, it is clear that the payments made by the taxpayer under the 1944 agreement during the taxable years involved were made to its principal stockholders, who were at all times in control of the taxpayer corporation, in proportion to their stockholdings in the taxpayer—except as to Dupar's individual ownership<sup>10</sup>—as the evidence amply shows (R. 105-106, 114-115, 118, 120, 130-131, 137, 141).

In this connection, Dupar testified, among other things, that since he had been instrumental in obtaining the taxpayer's 1931 lease and the lease-extension agreement of 1944, he therefore "wanted a guaranteed sum of money to come from the [taxpayer] corporation" to him each year thereafter (R. 114-115), and that when he insisted upon thus receiving such annual income from the taxpayer, Maltby and PCI likewise "decided to take some, too" based upon "the proportions determined by [their] stockholdings" in the taxpayer (R. 118, 120). Moreover, both Dupar and Thurston categorically testified that the chief reason for the payment agreement was to obtain a portion of the taxpayer's profits before they were all spent on the rehabilitation and maintenance of the hotel (Dupar, R. 105-108, 114-115; Thurston, R. 130-131, 141). Accordingly, it is clear, we submit, that this, without more, plainly shows that the payments in question constituted distributions of the taxpayer's

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<sup>9</sup> Western, which was to furnish general supervisory and hotel service to the Multnomah Hotel (R. 28, 110-111, 141-142), was owned 50% by Maltby, 25% by PCI and 25% by Frank Dupar (R. 29).

<sup>10</sup> It is immaterial that Dupar's payments received from the taxpayer during the taxable years involved were not in proportion to his individual stockholdings in the taxpayer. (See cases cited, *infra*.)

profits in the nature of guaranteed annual dividends to its controlling stockholder-payees in proportion to their stockholdings in the taxpayer, and therefore taxable income in each of the taxable years in which received by them, as the Commissioner correctly contended in the Tax Court (R. 46). *Auerback Shoe Co. v. Commissioner*, 21 T.C. 191, affirmed, 216 F. 2d 693 (C.A. 1st); *United States v. Currier Lumber Co.*, 70 F. Supp. 219, 221 (Mass.), affirmed, 166 F. 2d 346 (C.A. 1st); *Chesbro v. Commissioner*, 21 T.C. 123, 129, affirmed, *per curiam*, 225 F. 2d 674 (C.A. 2d), certiorari denied, 350 U.S. 995; *United States v. E. Regensburg & Sons*, 221 F. 2d 336 (C.A. 2d), certiorari denied, 350 U.S. 842; *Regensburg v. Commissioner*, 144 F. 2d 41, 44 (C.A. 2d), certiorari denied, 323 U.S. 783; *Kahn v. Commissioner*, 210 F. 2d 247 (C.A. 3d), certiorari denied, 347 U.S. 967; *Paramount-Richards Th. v. Commissioner* 153 F. 2d 602, 604 (C. A. 5th); *Davis v. United States*, 226 F. 2d 331, 334-335 (C.A. 6th), certiorari denied, 350 U.S. 965, rehearing denied, 351 U.S. 915; *United States v. Jolly* (W. D. Tenn.), decided July 15, 1954 (1955 P-H, par. 72,958), affirmed *per curiam*, 229 F. 2d 180 (C.A. 6th), certiorari denied, 351 U.S. 963, rehearing denied, 352 U.S. 860; *Chattanooga Sav. Bank v. Brewer*, 17 F. 2d 79 (C.A. 6th), certiorari denied, 274 U.S. 751; *United States v. Rosenblum* (S.D. Ind.), decided August 18, 1948 (38 A.F.T.R. 1607, 1610), affirmed, 176 F. 2d 321 (C.A. 7th); *Hadley v. Commissioner*, 36 F. 2d 543, 544 (C.A. D.C.); *Christopher v. Burnet*, 55 F. 2d 527, 528 (C.A. D.C.). Moreover, the courts held, variously, in the above cases that corporate earnings and profits may constitute dividends—particularly to stockholder-distributees wholly controlling and dominating the corporation, as here—whether or not the formalities of a



dividend declaration are observed, the distributions are recorded on the corporate books or made in proportion to the stockholdings, or some of the stockholders do not participate in the resulting benefits.<sup>11</sup>

Nor, in any event, were the payments in question "rentals", as contended by the taxpayer in the Tax Court (R. 45-46) and properly overruled by the Tax Court (R. 46). This is made clear by the facts of record which show conclusively that the only rentals involved in the case are the "minimum fixed monthly rental of \$7,000 per month", as provided by the terms of the original lease of 1931 (R. 40-41, 70), and the increased monthly fixed rental of \$8,500 a month as provided by the lease-extension agreement of 1944 (R. 44, 83), plus designated percentages of the taxpayer's annual gross revenues as provided by each of those lease agreements (R. 40, 69-70, 82-83), all of which were paid by the taxpayer directly to the lessor and had nothing to do with the payments here in question.

*B. The payments in question did not in fact constitute compensation for services actually rendered by the taxpayer's controlling stockholders during the taxable years involved.*

The Tax Court, without specifically specifying the personal services purportedly rendered by the three controlling stockholders (two of which were corporations) for which, it held, they received the disputed payments as extra compensation—over and above the regular salaries paid by the taxpayer to them or to persons who were their representatives as well as tax-

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<sup>11</sup> The record shows that Dupar never shared any of his payments received from the taxpayer with his stockholder associates (R. 105).

payer's (R. 19-20)—in carrying on the taxpayer's trade or business during the taxable years involved, within the meaning of Section 23(a)(1)(A), apparently had in mind both (1) the services *required* of Maltby and/or Western in the taxpayer's operation of the Multnomah Hotel pursuant to the terms of the original lease and the renewal thereof extended to mid-1961 (R. 40-44), and (2) the efforts of Thurston (representing Maltby), Schmidt (acting for PCI), and Dupar (for himself) in negotiating the original lease of 1931 (R. 42), and of Thurston (representing Maltby) and Dupar—without Schmidt (acting for PCI) (R. 44-45)—in negotiating the renewal thereof in 1944 (R. 43-44). Thus, the Tax Court stated (R. 46) that the basis for the taxpayer's payments in question was the services rendered "by the three payees" (Maltby, PCI and Dupar) prior to the execution of the original lease in 1931, and for services rendered prior to the execution of the renewal lease extension agreement in 1944, and also "for services to be rendered thereafter during the term of the lease and its renewal" extending to mid-1961. The record shows, however, that payee PCI (represented by Schmidt) rendered no services in the negotiations conducted by Thurston (representing Maltby) and Dupar leading up to and entering into the lease extension agreement of 1944 (R. 43-44, 45), and further that the payees or persons who were their representatives as well as taxpayer's received regular salaries from the taxpayer for their services during the life of the 1931 original lease and its renewal extension in 1944 (R. 19-20). Nor does the record contain any corporate resolutions of the taxpayer providing for



the payments in question as additional compensation for services of the stockholder-payees, over and above the regular salaries received annually from the taxpayer by them or persons who were their representatives as well as taxpayer's. Neither, contrary to the Tax Court's holding (R. 47-48), does it show that any of the payments in question were in fact made as "compensation" for services rendered by the stockholder-payees prior to the execution of the original and extended leases in 1931 and 1944, respectively, or thereafter for that matter (R. 46), as is evidenced by the fact that, insofar as this record shows, they or persons who were their representatives as well as taxpayer's received regular annual salaries from the taxpayer for *all* their services actually rendered to it during both taxable years involved as well as prior thereto (R. 19-20).

The record further shows that the terms of both the original lease of 1931 and likewise the lease-extension agreement of 1944 required that "the majority of the personnel" of the taxpayer was to be "the same as that of <sup>9</sup>Maltby and/or Western (R. 41, 44, 92, 94-95), but it contains no clear or satisfactory explanation of what was meant by that provision.<sup>12</sup> Western, organized in 1930 as a hotel service organization to render general services to all hotels for a consideration, and whose stock ownership was the same as the taxpayer's—except for Dupar's personal ownership (R. 26, 28-29)—supplied supervisory and operational services to the taxpayer but

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<sup>12</sup> The implication is, of course, that the taxpayer was to have the same officers and personnel as Maltby and Western had because they were experienced owners and operators of long standing, with wide interests in various hotel businesses. (R. 26-40, 48, 62.)

was adequately paid for those services by the taxpayer (R. 139-142). A majority of the officers of the taxpayer were at all times the same as those of Maltby and/or Western, including, in 1931, Thurston, Schmidt and Dupar and, in 1944, Thurston (of Maltby and Western), F. M. Kenney (of PCI and Western), and Dupar (of Maltby and Western). (R. 18-23, 33-40.) All of those individuals, (except Kenney), however, received substantial annual salaries as officers of the taxpayer during its first year of incorporation and operation (1931) and thereafter (except Schmidt) through the taxable years here involved. (R. 19-20.) Nor is there any evidence in this record to show or indicate that their salaries were not adequate to compensate them for whatever services they performed for the taxpayer in connection with the operation of the hotel during the earlier years and/or the taxable years. Hence, there is no basis in the record to support the Tax Court's gratuitous conclusion that the payments in question—in addition to the regular annual salaries paid by the taxpayer—were for services rendered by the three stockholder-payees not only prior to the execution of the original lease in 1931 and the renewal thereof in 1944 but also “for services to be rendered thereafter [by them] during the term of the lease and its renewal” (R. 46), running to mid-1961 (R. 44).

Moreover, it is clear that if the negotiations leading up to the execution of the original lease agreement in 1931 and the renewal lease-extension agreement of 1944 constituted services rendered to the taxpayer by the controlling stockholder-payees, as the Tax Court held (R. 46, 48), then such payees have long since

been fully compensated therefor, certainly long before the taxable years here involved. This is shown by the record which discloses that during the approximate 10-month period prior to the execution of the original lease in 1931, Thurston (president of and representing Maltby), Schmidt (trustee of and representing PCI) and Dupar (representing himself) conducted negotiations which resulted in the acquisition of the original hotel lease of June 17, 1931, by Maltby and shortly thereafter (June 30, 1931) assigned by it to the taxpayer (R. 40-42) which, as pointed out, was a corporation organized for the express purpose of becoming the operating company for the hotel (R. 41). The record also shows that Thurston and Dupar carried on the negotiations for the lease-extension agreement obtained in 1944 (R. 43-44) while they were both officers of Maltby and Western (R. 18, 21) and also, at the same time, salaried officers of the taxpayer (R. 19). And again, there is no evidence in the record to show or even indicate that their services in negotiating the lease-extension agreement of 1944 were performed for or in behalf of anyone other than the taxpayer, nor, since neither of them ever actually "did \* \* \* work full time for the [taxpayer] petitioner" (R. 138-139), that their regular salaries received as such from the taxpayer annually (R. 19) were not fully adequate to compensate them for the *part-time* services which they only rendered for the taxpayer.<sup>13</sup> Finally, contrary to the Tax Court's

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<sup>13</sup> Both Thurston and Dupar had wide interests in various hotel organizations, as pointed out, and not only did they never work full time for the taxpayer but also, as Thurston testified (R. 139): "We don't work full time for any of them [hotels] excepting when we are called upon and have work to be done."

contradictory finding that the basis for the alleged compensatory payments here in question was “services rendered by *the three payees*” (italics supplied) (Maltby, represented by Thurston; PCI, represented by Schmidt, and Dupar, for himself) prior to the execution of the original and renewal extension lease agreement of 1931 and 1944, respectively (R. 46, 48), its findings also show, as we have indicated above, that Schmidt (trustee of PCI) as far as the 1944 lease extension agreement is concerned neither participated in these negotiations nor rendered any services for or in behalf of the taxpayer in connection therewith.<sup>14</sup>

In the 1944 payment agreement (R. 92-97, Ex. 5), pursuant to which the disputed amounts were paid by the taxpayer to its controlling stockholder-payees during the taxable years here involved, reference is made to the “assurance” of Maltby to the lessor that “the majority of the personnel” of the taxpayer would be the same as that of Maltby and/or Western, and also the agreement of Maltby and Western “to co-operate” with the taxpayer in the successful operation of the hotel and to give it such assistance as they properly could (R. 94-96). It is clear, however, that such *assurance* of Maltby and the *cooperation* with the taxpayer, as agreed to by Maltby and Western, can hardly be properly construed as services rendered to the taxpayer then or later, nor does the extension agreement of 1944 provide or indicate that the payments here in question were to be made to compensate

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<sup>14</sup> In this connection, the Tax Court found (R. 43-44, 45) in respect of the lease renewal negotiations in 1944 that Schmidt, as trustee for PCI, had “taken no part therein,” and that he “did not in fact aid in the procurement of the [lease] extension agreement” in that year.



for any services performed or to be performed by the taxpayer's controlling stockholder-payees in relation to the above-mentioned items. (R. 94-95.) Those items listed as "considerations" clearly did not represent and could not have constituted consideration for the agreement for neither Maltby nor Western is shown by this record to have suffered any detriment by giving their assurance that "the majority of the personnel" of the taxpayer would be the same as their own personnel and/or by agreeing to cooperate with the taxpayer in the operation of the hotel (R. 94, 95) for which, as shown, their officers and representatives who were also officers of taxpayer regularly received annual salaries from the taxpayer (R. 19-20). Such assurances and promised cooperation, very clearly, were merely part of the original plan of the interested parties designed for the success of the new hotel venture and no more than what was expected to result in profits to Maltby, PCI and Dupar as controlling stockholders of the taxpayer in the operation of the hotel. (R. 128-129.) The record shows that such obligation of Western, specifically organized to render supervisory and general management services, etc., to all hotels (R. 28), was not considered detrimental or prejudicial to it in any way with respect to the development and operation of the taxpayer's hotel property but rather, as Dupar testified (R. 110), "I would figure that was a compliment." Indeed, rather than being detrimental to Maltby and/or Western, it was clearly highly beneficial for them to have the majority of their officers and personnel to act as officers and personnel of the taxpayer, particularly in view of the fact that Maltby, as the largest controlling



stockholder of the taxpayer (R. 26), could, and in fact did, thereby select its own officers (R. 18-19, 21-22, 33-35, 37-38) to act in key positions as the taxpayer's officers (R. 19-20, 35-36).

Moreover, the 1944 payment agreement contains further features tending to negative the Tax Court's conclusion (R. 47-48) that the payments made to the taxpayer's controlling stockholders represented compensation for services. Thus, the record shows that PCI (represented by Schmidt) was one of the payees (R. 44, 46) but was neither a party to the agreement (R. 92) nor, according to the provisions of the agreement itself, was it to furnish, nor did it furnish, any of the alleged considerations therefor (R. 94-96). Neither was Dupar, though one of the payees under the agreement (R. 42, 46), a party to the payment agreement<sup>15</sup> and none of the alleged considerations are shown to have moved from him to the taxpayer for the payments here in controversy<sup>16</sup> (R. 43-44). Finally, though Western was a party to the payment agreement (R. 92) and is said to have furnished some of the alleged consideration therefor (R. 94-96), yet the record shows that it was at all times otherwise

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<sup>15</sup> Both PCI and Dupar merely gave their approval to the agreement. (R. 97.) This was done pursuant to the provisions of Paragraph 1 thereof. (R. 93-94.)

<sup>16</sup> Since Dupar's personal participation in the lease extension negotiations had taken place during the early part of 1944, it is a little difficult to see how the taxpayer's payments in question, made during the taxable years 1948 and 1949 pursuant to the 1944 payment agreement, can qualify currently as deductions for compensation for the taxable years involved for services actually rendered several years earlier. Services rendered in 1944 can hardly be projected several years thence to 1948 and 1949 for compensation deduction purposes especially when there had been payments under the 1944 agreement during the intervening years.

fully compensated for its services rendered to and in behalf of the taxpayer beginning with its corporate inception in 1931 (R. 29, 110-111) and further that it was not a valid payee except indirectly in the sense that its stockholders (Maltby, PCI and Frank Dupar (R. 28-29)) were payees (R. 44, 46).

The evidence of record further fails to support the Tax Court's conclusion (R. 47-48) that the disputed payments made by the taxpayer to Maltby, PCI and Dupar during the taxable years constituted compensation for personal services actually rendered to the taxpayer by the three controlling stockholders in the ordinary course of its business during those years. Certainly the testimony of the two principal witnesses (Thurston and Dupar), who were also officers of the taxpayer, offers little, if any, support therefor. As the Tax Court stated in its opinion (R. 47), Maltby (represented by Thurston), PCI (represented by Schmidt) and Dupar representing himself "were the parents responsible for its [taxpayer's] birth" in 1931. The record shows that these parties had joined together in 1930 in organizing Western, a general hotel service organization, as pointed out, in order to eliminate competition among themselves and thereafter to act in concert for their mutual benefit in their various hotel businesses (R. 28-29,) and thereupon in 1931 they planned to obtain a lease on the Multnomah Hotel in Portland, Oregon, and to assign the lease to a new corporation (taxpayer) to be organized for the operation of the hotel which, in turn, was to be supervised generally and serviced by Western (R. 40-42). Upon their obtaining the lease in Maltby's name in 1931 (R. 99), it was shortly thereafter assigned by Maltby to the

taxpayer in that year (R. 41-42), and at the same time a separate agreement was executed under which Maltby, PCI and Dupar (the taxpayer's principal stockholders, as previously shown (R. 26)) were to receive payments from the taxpayer in the total sum of \$2,500 a month, aggregating \$30,000 a year (R. 42-43).

Frank Dupar, the principal motivating factor in respect of the payment agreement of 1931 (R. 42, 101-102), testified that he considered that he, "just a minority stockholder" of the taxpayer, was entitled to something for having done what he called "all the work" in negotiating the lease (R. 102), and that, as a minority stockholder in the taxpayer, he feared that Maltby and PCI "would wish to retain [taxpayer's] earnings to take care of the rehabilitation [of the hotel] or other purposes", and therefore he "wanted a guaranteed sum of money to come from the corporation [taxpayer]" to him "each year" (R. 114-115). Upon his insistence that he receive something *each year* for the part he played in the negotiations for the original lease in 1931, Maltby and PCI likewise decided to take something too, that is, annual earnings from the taxpayer (R. 42-43, 123-124), based on "the proportions determined by [their] stockholdings" in the taxpayer (R. 118), "and this proportion of thirty thousand [dollars annually, paid at the rate of \$2,500 a month by the taxpayer] was again based on [the] stockholdings" of Maltby and PCI in the taxpayer, but not on Dupar's minority stockholdings therein (R. 120).<sup>17</sup> Thurston, representing Maltby, testified that he believed that the payment

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<sup>17</sup> Frank Dupar's share of 25% was not based on his stockholdings in the taxpayer for, as pointed out, he himself did not own a full 25% share thereof (R. 26, 123-124). However, he and his associates did own a full 25% share in taxpayer.

agreement “was predicated a great deal upon the services rendered.” (R. 137.) As to whether or not it was true that the 50% paid Maltby and the 25% paid Schmidt, as trustee for PCI, “was coincidentally proportionate to the stockholdings of those two in the petitioner [taxpayer]”, Thurston, without denying such proportionate payments, stated that “The facts are there to show for themselves” in connection therewith. (R. 137.)<sup>18</sup> Moreover, both Dupar and Thurston categorically testified that the principal reason for the payment agreement was for the purpose of obtaining a portion of the taxpayer’s profits before they were entirely spent on the rehabilitation and/or maintenance of the hotel (Dupar, R. 105-108, 114-115; Thurston, R. 130-131, 147). In harmony with the foregoing evidence, the Tax Court found as facts that, over and above the \$625 monthly payment (\$7,500 a year) received by Dupar from the taxpayer (R. 42-43), “The remainder [\$1875 a month, or \$22,500 a year], it was agreed [by taxpayer’s controlling stockholders Maltby, PCI and Dupar], would be divided between PCI and Maltby *in proportion to their respective stock holdings in [taxpayer] petitioner*” (R. 43). (Italics supplied.)

The record further discloses that the taxpayer’s controlling stockholder payees of the sums in question failed to remember and, in any event, were unable to explain how and/or on what basis the amounts of the disputed payments were arrived at and determined.

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<sup>18</sup> Since the facts of record show that the taxpayer’s \$2500 monthly payments, aggregating \$30,000 a year, were in fact made to Maltby and PCI in proportion to their stockholdings in the taxpayer, it is clear that witness Thurston’s reliance on the facts as speaking for themselves, thus concedes the proportionate payments on the basis of the payees’ (except Dupar’s) stockholdings in the taxpayer.



(R. 121-123, 136-138.) Thus, Thurston, when asked whether or not the payments in question “represented a fair compensation for the services and liability and responsibility which was involved” (R. 131), testified (R. 131, 132) that—

We felt that it did at that time.

\* \* \* \* \*

We felt that it did. We recalled all of the work we had done in it, the speculation that was involved and the work that was staring us in the face in order to make it a successful enterprise; therefore, we felt it was a fair deal.

Dupar testified that when the lease was extended in 1944 and the new payment agreement (R. 92, Ex. 5) was executed, the parties thought that they “were entitled to something” for giving up a lower rent on the hotel for the remaining  $2\frac{1}{2}$  years of the original lease (R. 112-113), although Thurston testified that an extension of the lease was desirable and had been sought even earlier (R. 132-133). Dupar further testified that at that time the hotel had “very high” *net* earnings and was a successful venture (R. 108); there also was no longer any danger that *all* of the taxpayer’s “future earnings would have to be plowed back [into the hotel] for repairs and maintenance”, as was the condition existing back in 1931 (R. 119-120); and as to how the new payment agreement of 1944 was determined, “It was just a continuation of what we had before” (R. 121), and “We just extended it”, that is, the original payment agreement of 1931 (R. 122-123). Thurston testified that the first agreement “had been carried on without any contest from anybody”, and they thought



that they were just as much entitled to payments as previously, "and so we just didn't raise the question any further or go into any discussion as to any modification of it" (R. 133); and when he was asked why Maltby still received 50% of the payments after 1946 when it was no longer a party to the lease, he stated that Maltby "still had the same stockholdings" in the taxpayer (R. 125-126). Finally, Thurston at one point in his testimony referred to the payments in question as having been "lease rent" which constituted "dividends" received by taxpayer's controlling "stockholders \* \* \* for a number of years" (R. 136),<sup>19</sup> and earlier he had testified in respect of the payments in question, totalling \$30,000 a year, that "I don't know how you would refer to it unless it would be as a rental" (R. 134-135).

In view of the foregoing, it is clear that this case simply reflects control and domination of the taxpayer by its three principal stockholders. Those stockholders (Maltby, PCI and Dupar) were undoubtedly responsible for the taxpayer's success but it was *as stockholders* that they operated. The over-all picture seems clearly to be one whereby these controlling stockholders of the taxpayer required the taxpayer to make certain fixed annual payments to them, in proportion to their stockholdings, as the evidence shows, because one of those stockholders (Dupar), originally wanted, indeed insisted upon, an annual return on his investment from

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<sup>19</sup> Thurston, when asked whether there was a net profit earned by the taxpayer every year commencing with its incorporation in 1931, replied (R. 136) that—

I believe there was a net profit, but it was all spent in the rehabilitation of the properties. I don't think any of *the stockholders got any dividends outside of this lease rent for a number of years.* (Italics supplied.)

this particular hotel venture of the taxpayer. Moreover, it is highly significant, we submit, that there was no allocation or attempted allocation of the payments according to the controlling stockholder-payees' alleged services rendered to the taxpayer but only in proportion to their (except Dupar's) <sup>20</sup> stockholdings in the taxpayer. For such services as were actually rendered to the taxpayer, the individuals (stockholder-officers) rendering the services clearly otherwise received adequate compensation as salaries from the taxpayer for all years involved insofar as this record shows. (R. 19-20.)

### III

**Assuming That the Payments in Question Constituted Compensation for Services Rendered by the Controlling Stockholders to the Taxpayer During the Taxable Years, They Are Not Shown by the Record to Have Constituted Reasonable Compensation Allowable as Deductions Under the Statute**

The statute allows as deductions all ordinary and necessary business expenses paid or incurred during the taxable year, including "a reasonable allowance for salaries or other compensation for personal services actually rendered" to the taxpayer. Section 23(a)(1) (A) of the 1939 Code, *supra*; see also Section 29.23(a)-6(1)(a) and (3) of Treasury Regulations 111, *supra*. The Tax Court held that the \$30,000 annual payments in question not only constituted compensation for services rendered to the taxpayer by its three controlling stockholders in the ordinary course of its business within the meaning of the statute but also that "such compensation is not unreasonable" and therefore is deductible

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<sup>20</sup> However, as pointed out, if Dupar's associates' stockholdings are included in his share the allocation as to him was also on the basis of stock ownership.

by the taxpayer for each of the taxable years involved (R. 47-48.)<sup>21</sup> We submit that, upon this record, the Tax Court's holding is not supported by the evidence or otherwise, and is therefore clearly erroneous and should properly be reversed upon review by this Court.

The record shows that the taxpayer, under the respective 1931 and 1944 payment agreements, made payments to its three controlling stockholders totalling \$30,000 a year, or approximately \$540,000 from 1931 through 1949 (the last taxable year involved, no such payments having been made during an undisclosed short portion of the first year (1931) when the taxpayer was organized. (R. 43.) The record further shows that (a) 25% of the taxpayer's annual payment in question, or \$7,500, was made to a stockholder-corporation (PCI, represented by Schmidt) which concededly rendered no services to the taxpayer, as the Tax Court itself found (R. 44, 45), (b) 50% thereof, or \$15,000, was paid to another stockholder-corporation (Maltby, represented by Thurston) whose only claim to have rendered services to the taxpayer was through its president (Thurston (R. 42-43, 44)), who at the same time was the president of the taxpayer from which he regu-

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<sup>21</sup> The Tax Court stated that while the Commissioner contended that the taxpayer's \$2,500 monthly payments (totalling \$30,000 annually) to its three controlling stockholders were in excess of the true rental value of the hotel premises, yet "he makes no contention that they are excessive or unreasonable as compensation" for the taxable years involved. (R. 48.) Needless to say, no such contention was made or could have been made by the Commissioner below for the very obvious reason that the question whether the disputed payments constituted compensation, reasonable or otherwise, was not in issue in the Tax Court, nor would the Tax Court permit the Commissioner a further hearing, as requested (R. 49-53), in order to afford him an opportunity to present evidence and argument in respect of such new issue, as shown in Point I, *supra*.

larly received a substantial annual salary from 1931 through the last taxable year here involved (R. 19-20), and (c) the remaining 25% of the annual payment (\$7,500) was paid to Dupar who was the secretary of the taxpayer and likewise receiving a regular annual salary from the taxpayer during all of those years (R. 19-20).

The taxpayer, of course, had the burden of proving that the payments in question constituted *reasonable* compensation for personal services actually rendered to it during the taxable years involved, but it did not even contend in the Tax Court that the disputed payments constituted compensation for services rendered it, nor did it raise the issue in the pleadings. It contended, rather, that the disputed payments constituted proper deductions as rentals paid by it during the taxable years (R. 45-46), as shown under Point I, *supra*. The Tax Court, however, as pointed out above, of its own initiative, gratuitously determined and held both that the payments constituted, not rentals (R. 46) but rather, compensation for services, and that "such compensation was not unreasonable" and therefore was deductible by the taxpayer for the taxable years involved (R. 47-48). This holding in respect of reasonableness is, of course, as vague, especially in the light of the evidence of record, as is its other holding that the payments constituted compensation for services rendered to the taxpayer.

It is clear that a reasonable allowance for compensation for services rendered within the meaning of the applicable statute and Regulations can be determined only on the basis of a showing of the particular services rendered and specifically what constitutes reasonable



compensation for such services. As pointed out under Point II (B), *supra*, the Tax Court did not specify, nor does the record disclose, the precise nature of the alleged services rendered to the taxpayer by each of its three controlling stockholder-payees for which the payments in question purportedly constituted compensation as erroneously held by the Tax Court. In these circumstances, it is clear that there is no possible basis in this record for the Tax Court's gratuitous determination and unsupported holding. (R. 47-48) that the payments in question constituted compensation for services at all, much less a "not unreasonable" compensation within the meaning of Section 23(a)(1)(A).

In view of the foregoing, we submit that the Tax Court's decision in respect of both compensation and the purported reasonableness thereof is wholly unsupported by the evidence of record, much less substantial evidence as is required in order to be sustainable; is therefore clearly erroneous; and should accordingly be reversed by this Court without remand to the Tax Court. *United States v. Gypsum*, 333 U.S. 364, 394-395, rehearing denied, 333 U.S. 869; Rule 52(a) of the Federal Rules of Civil Procedure. Moreover, since the record shows that the Tax Court decided this case on a basis neither pleaded nor argued by the taxpayer, and in respect of which the Commissioner was afforded no opportunity to present evidence and argument, it necessarily follows, we submit, that the conclusions reached by it as a matter of law have no foundation in the evidence, and that at a minimum and in any event, the case, if not reversed in favor of the Commissioner by this Court upon review, should be remanded to the Tax Court, to the end that the factual issues upon which



the Tax Court's erroneous decision turned may be adequately developed and corrected upon remand and rehearing below.

#### CONCLUSION

The decision of Tax Court is in all respects incorrect and not in accordance with law, and should therefore be reversed in favor of the Commissioner upon review by this Court, or, in any event, remanded to the Tax Court for further and proper hearing in respect of the issue involved.

Respectfully submitted,

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APRIL, 1957.

No. 15370

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**United States Court of Appeals  
For the Ninth Circuit**

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COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

vs.

MULTNOMAH OPERATING COMPANY, *Respondent*

---

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX  
COURT OF THE UNITED STATES

---

**BRIEF FOR THE RESPONDENT**

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FILE

MAY - 2 1957

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# United States Court of Appeals

## For the Ninth Circuit

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COMMISSIONER OF INTERNAL REVENUE,  
*Petitioner,*

vs.

MULTNOMAH OPERATING COMPANY,  
*Respondent.*

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No. 15370

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX  
COURT OF THE UNITED STATES

### BRIEF FOR THE RESPONDENT

#### JURISDICTION

The jurisdiction of this court is founded upon 26 USC, Sec. 7482, which provides:

“(a) Jurisdiction—The United States Court of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in Sec. 1254 in Title 28 of the United States Code, in the same manner and to the same extent as decisions of the District Courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari in the manner provided by Sec. 1254 of Title 28 of the United States Code.”

“(c)(1) Upon such review such court shall have the power to affirm or, if the decision of the Tax Court is not in accordance with law, to modify or to reverse the decision of the Tax Court, with or without remanding the case for rehearing, as justice may require.” . . .

## STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

“Sec. 23. DEDUCTION FROM GROSS INCOME.

“In computing net income there shall be allowed as deductions:

“(a) Expenses.

“(1) Trade or Business Expenses.

“(A) In General—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of the trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, or property to which the taxpayer has not taken or is not taking title or in which he has no equity.”

Regulations 111 Sec. 29.23(a)-6:

“*Compensation for personal services.*—Among the ordinary and necessary business expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. . . .”

“(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. . . .”

“(3) . . . The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date the contract is questioned.”

### STATEMENT OF FACTS

The parties stipulated the factual matter appearing at pages 25-40 of the record on appeal,<sup>1</sup> and the Tax Court adopted the stipulation as part of its findings. This material together with the other evidence contained in the record on appeal, can be summarized as follows to clarify what is at best a complex factual situation:

1. Multnomah Operating Co. (herein called Multnomah) was the eventual lessee of the Multnomah Hotel property (Ex. 2, R. 77). It is the corporation that made the payments here in question and that claims the deductions which the Commissioner seeks to have disallowed. Multnomah was incorporated about 1931 for the purpose of taking title to the leasehold estate and operating the Multnomah Hotel property. On July 1, 1931, its 250 shares of issued and outstanding capital stock were owned by 9 persons (R. 26). Among these were the following:

<i>Name</i>	<i>No. of Shares</i>	<i>Percentage of Total</i>
1. F. A. Dupar.....	17	6.8%
2. Maltby-Thurston Hotels, Inc. (herein called Maltby).....	123	49.2%
3. Peter G. Schmidt (Trustee for . Pacific Coast Investment Co., herein referred to as PCI).....	62	24.8%

<sup>1</sup>References to pages 25-40 of the record on appeal are references on the Tax Court findings rather than evidentiary material as such, but are



The capital stock of taxpayer corporation was thereafter in large part deposited in a voting trust, and the beneficial ownership of the stock in that trust remained substantially unchanged during all times material to this case (R. 26). The total issued and outstanding stock during the period of the voting trust was held by an undisclosed number of shareholders, in any event more than the four who participated in the voting trust (R. 26). Included among these were:

<i>Name</i>	<i>No. of Shares</i>	<i>Percentage of Total</i>
1. F. A. Dupar .....	17	6.8%
2. Maltby .....	124	49.6%
3. PCI .....	611½	24.6%

2. Reference is made in the findings of the Tax Court and throughout the record, to three corporations other than Multnomah, which were involved in the over-all transaction. None of them is a party to this case, none paid any of the money in question, and none claims any income tax deduction. For the purposes of identification and clarity of analysis, these may be briefly described as follows:

(a) Maltby's relationship to taxpayer is that of stockholder and assignor of the leasehold under which taxpayer has held possession of the Multnomah Hotel property (R. 26, 42). The distribution of Maltby stock was scattered over 7 to 9 persons during the times material to this suit. Mr. F. A. Dupar was not a stockholder when the Multnomah lease was first signed. He acquired stock subsequent to 1944 in amounts that eventually totalled 3.5% of the outstanding stock (R. 27, 28).

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given as that part of the Tax Court findings as a recital of the stipulated facts.

(b) The relationship of PCI to taxpayer was solely that of stockholder (R. 26), and while it received a part of the payments here in question, its tax liability is in no way in issue. This corporation during the time in question had between 10 and 33 shareholders (R. 29, 30, 31). F. A. Dupar was never a stockholder in PCI. Maltby was not until 1944 when it acquired a substantial block of shares (R. 32).

(c) Western Hotels, Inc. (hereinafter called Western), neither paid nor received any of the money in question and its relationship with taxpayer was merely that of a management concern which furnished services to a number of hotel properties, including the Multnomah Hotel (R. 110, 140, 141). Its compensation for this service was in the form of fees paid by the hotels that use its services (R. 139, 140). Western has never held stock in taxpayer (R. 26). It was formed about 1930 by a group of hotel operators for the purpose of concerting their operations and resources (R. 28). When the Multnomah lease was first negotiated, Western had 21 stockholders. By 1944 and thereafter its stock was recapitalized and the issued and outstanding stock was owned 25% by F. A. Dupar, 25% by PCI and 50% by Maltby (R. 29).

3. At the time the events involved in this case began, the Multnomah Hotel was in serious financial difficulties and the prospects for immediate improvement of its business were poor (R. 105), it being in the depression of the 1930's. At that time Maltby, Dupar and PCI, who previously were "bitter competitors" became interested in the Multnomah Hotel property (R. 105). Maltby was represented by S. W. Thurston and PCI

by Peter G. Schmidt. The arrangement eventually worked out was to vest the leasehold in taxpayer corporation, which was formed for that purpose and for the purpose of operating the Multnomah Hotel. At the time of formation of taxpayer corporation, F. A. Dupar took 6.8% of the stock, PCI took 24.8% and Maltby took 49.2%, the balance being acquired by 6 other investors (R. 100, 26).

Negotiations for this lease were carried on by all three (Maltby, PCI and Dupar) the former being represented by Mr. Thurston and Mr. Schmidt, respectively, as stated above (R. 99). They negotiated continuously for between 10 months and a year before the deal was closed (R. 100), and during that time approximately 20 trips were made by them from Seattle to Portland (R. 100), these trips taking up to 2 days each (R. 128). All three negotiated actively and their labors were approximately equal (R. 117, 118).

4. The transaction was finally closed on the basis of the owner's executing and delivering to Maltby a 15-year lease having a minimum rent of \$7,000.00 per month with provision for additional percentage rent, and having among other things a provision permitting assignment to Multnomah as an operating corporation on condition that the majority of the personnel of Multnomah would be the same as that of Maltby and Western (R. 71, 72, 73). The principal executive officers of Multnomah on the date of the assignment were: S. W. Thurston, President; F. A. Dupar, Secretary, and Peter G. Schmidt, Treasurer (R. 35). These individuals had had long experience as hotel operators

(R. 99). As the lease required, these individuals, officers of Multnomah, were the same as the principal officers of Maltby and Western (R. 34, 37), except that in later years one F. M. Kenney, who represented PCI, (R. 39), replaced Mr. Schmidt as an officer of Western (R. 37). This personnel factor governed the deal so far as Hauser Securities Company was concerned (R. 129), and in this connection the original lease contains the following recital:

“This lease to a large extent is based upon the personnel of the present officers of said lessee and their ability to conduct and operate a first-class hotel, and by reason thereof lessee covenants and agrees not to assign this lease nor sublet nor underlet nor permit any other person or persons to occupy said premises . . .”

“Provided, further, that it is understood and agreed that the within lessee contemplates the forming of an Oregon corporation to whom the within lease may be assigned by it, the majority of the personnel of which will be the same as that of the within named lessee and/or Western Hotels, Inc. . . .”

The Multnomah lease further required security for performance of the lease covenants and Maltby, PCI and Dupar, the payees of the money here in question, furnished this security in the form of guarantees and in the case of Maltby, a transfer of its stock (R. 104). This security was furnished 25% by Dupar, 25% by PCI and 50% by Maltby (R. 129, 130). It was essentially a suretyship of the taxpayer's leasehold obligations by these three stockholders of taxpayer, and tax-

payer eventually reimbursed them for their outlay of principal (R. 104, 105).

5. Collateral to the negotiations of the basic lease with Hauser Securities Company and the arranging for its assignment to Multnomah, there was a negotiation by Dupar, Maltby and PCI for a consideration to be paid to them, but not the other stockholders of Multnomah. This payment was to be made by Multnomah. The amount eventually settled upon was a monthly payment of \$2,500.00, \$625.00 of which was to go to F. A. Dupar, \$625.00 to PCI and \$1,250.00 to Maltby. These payments are the subject of this law suit. The payments were understood to be conditioned upon there being sufficient earnings to make them (R. 137). They were in fact made in the amounts stated with the exception of certain interruptions during depression years. No part of them was shared by the recipients with any other stockholders of Multnomah (R. 105).

The basic lease by its own terms was to expire in 1946, but in 1944 a 15-year extension was renegotiated (Ex. 3, R. 81). At that time there was very serious concern over post-war conditions due to predicted depressions (R. 107), the prospect of serious competition (R. 111), and the need for spending a large sum of money to rehabilitate the hotel which had run down because of priority restrictions and war-time regulations (R. 108). Hauser Securities Company was insistent that the same personnel provisions be included in any extension (R. 111). As finally negotiated, the new lease raised the basic rental (which had priority over the payments here in question) to \$8,500.00, which was done with the agreement of F. A. Dupar, PCI and Maltby, although



they had two and one-half years to go under their payment agreement, and although it was felt by these three, from their personal standpoint, that they "were signing up with the Hausers for another 15 years and that (they) would have to stay with them and not get into negotiations on a new hotel with other people" (R. 112).

The supplemental payments to Dupar, Maltby and PCI were extended by written agreement which bears the signature of all three (although Dupar and Schmidt signed as having accepted it rather than as a party) (Ex. 5, R. 82). This agreement provides in part:

"Whereas on June 17, 1931, an indenture of lease was entered into between Hauser Securities Company . . . and Maltby-Thurston Hotels, Inc. . . . which lease was negotiated by Maltby-Thurston Hotels, Inc. by and with the participation and assistance of Peter G. Schmidt, Trustee, and Frank A. Dupar; . . .

"Whereas, said lease, unless otherwise extended, would by its terms terminate on July 1, 1946, and the parties are desirous of securing an extension of said lease, and such extension has been negotiated by and with the assistance of Maltby-Thurston Hotels, Inc., Peter G. Schmidt, Trustee, and Frank A. Dupar, and such extended lease provided for the minimum rentals to be paid thereunder in larger amounts than previously, and that such rental provisions are to take effect as of February 1, 1944, rather than to await the expiration of the original term of said lease, all of which has been consented to by Maltby-Thurston Hotels, Inc., Peter G. Schmidt, Trustee, and Frank A. Dupar, whose payments from Multnomah Operating Company may be affected thereby; . . .

“2 (Multnomah) agrees that one of the considerations by which it was able to secure the extension and amendment of said lease was the assurance . . . that the provisions . . . of the original lease would be continued in force with respect to the covenant that the majority of the personnel of (Multnomah) would be the same as that of Maltby-Thurston Hotels, Inc., and/or Western Hotels, Inc. . . .

“3. The party of the second part (Multnomah) agrees that the extension of said lease has been procured through the efforts of personnel of Maltby-Thurston Hotels, Inc. and of Western Hotels, Inc. with personal assistance of Frank A. Dupar and S. W. Thurston. In consideration of procuring such extension and in consideration of the other covenants, terms and provisions of this agreement, Multnomah Operating Company agrees that the monthly payment of \$2,500.00, which was the consideration for the assignment of said lease, shall continue to the end of the full extended term . . .”

6. The three “payees,” Maltby, PCI and Dupar, have sometimes referred to their payments as rent (See e.g. R. 135), but during the trial there was a demonstrated uncertainty about the correct characterization of this income (R. 114, 134, 135). The witnesses at the trial, Dupar and Thurston, described in detail the underlying motivation for demanding and receiving the payments, as well as the factual background which they thought justified them. The following circumstances bear on this point. A great deal of time and effort was expended by Dupar, PCI and Maltby in organizing the venture (R. 99, 100, 117, 118,

128). Multnomah Hotel was in extremely bad financial condition in 1931, and its prospects for improvement were questionable (R. 105). In addition, the property was badly run down and needed large outlays of capital for rehabilitating it (R. 99, 106), which was likely to drain off all the operating revenues from the property (R. 106). Two of the three payees were in the position of being minority stockholders in Multnomah (R. 26), with no control over operating expenditures, and it was particularly feared by Dupar (R. 106) that this might result in their not getting a return for their work in the transaction (R. 102). Furthermore, as previously stated, the lease was conditioned upon Multnomah obtaining and keeping the same personnel as Maltby and Western, these being Dupar, Thurston, who was the representative of Maltby, and Schmidt, who was the representative of PCI. Also, these three individuals were required to guarantee up to a stated amount on the purchase price of stock to be deposited as collateral security for performance of the lease covenants. There was thought to be great risk in the venture (R. 124) both at the time of the original lease (R. 105) and the 1944 extension (R. 111). Taxes were not considered and were not a motivation for the payments (R. 106).

Throughout their testimony, witnesses Dupar and Thurston repeatedly described the payments from taxpayer as being an earned payment for their work and services in the Multnomah Hotel venture (R. 102, 106, 131, 132, 134, 137).

7. On the subject of compensation, the Tax Court in its memorandum decision found as follows:

“... In the light of the testimony of Dupar and S. W. Thurston, who represented Maltby in all the transactions here involved, it is clear that the basis for the payments was services rendered by the three payees prior to the execution of the original lease in 1931 and also prior to the execution of the renewal agreement in 1944, and for services to be rendered thereafter during the term of the lease and its renewal.”

“We are impressed, ... that this record fully substantiates the conclusion that whatever the petitioner has named the amounts sought to be deducted, they were compensation for services rendered in the ordinary course of petitioner’s business within the meaning of Sec. 23(a)(1)(A). . . . We think that in the light of the long experience of all three payees in the hotel business and in view of their efforts in negotiation of the original lease and the efforts of Dupar and Maltby in the negotiation of the renewal thereof, together with other services required of one or the other of them during the lease and its extension and agreements in pursuance thereof, such compensation was not unreasonable. . . .”

### SUMMARY OF ARGUMENT

1. The burden is on appellant to prove that the Tax Court was “clearly in error,” and by applicable statute, rules of procedure and this court’s own decisions, the decision below must be upheld unless that burden is met. The question of whether the payments were made as compensation, reasonable in amount, is one of fact for the trial court, and great weight must be given to the trial court’s opportunity to evaluate the credibility of witnesses.



2. There is no merit in the contention that the Tax Court, as a matter of procedure, was not entitled to find that the payments were deductible as compensation under Sec. 23(a)(1)(A) of the Internal Revenue Code. There was actually no new issue "injected in the case," because the fact that the taxpayers as laymen sometimes referred to the payment as rental payments for their services rather than compensation payments for their services, does not in any way alter the circumstance that they *were* payment for services, which is the ultimate fact that creates and controls the tax situation as was found by the Tax Court. In any event, the Tax Court is entitled to decide the case upon the facts of record so long as it does not rely upon facts not so established. It is on this ground that the authorities cited by petitioner are readily distinguishable. This is an unusually complete record of the transaction, and it is particularly important to note that petitioner was either unwilling or unable to suggest in its motion for rehearing, amendment to motion or brief on appeal, what evidence it could produce to amplify the present record if the case were reopened. The counsel for the Commissioner had and used the opportunity to make a searching cross-examination of the witness on all of the testimony relied upon by the Tax Court, and in addition, all of the detailed evidence concerning the services and undertakings rendered to taxpayer by the three payees was admitted without objection or exception.

3. In addition to supplying the required "substantial evidence," this record affirmatively and compellingly demonstrates that the Tax Court was correct in its decision. At the time of the original lease the three



payees rendered extensive and valuable services in securing the lease and establishing the Mulnomah Hotel as a going business. This took place in the bottom of the depression of the 1930's, when the hotel was badly run down, physically and financially, and the venture was attended by great risk. In addition to these services, the three payees, as individuals, were obliged to pledge their personal credit to secure performance of the lease by taxpayer up to an aggregate amount of \$75,000.00, which was a very substantial sum in those days, particularly in view of the financial condition of the payees themselves. These guarantees were by direct payments, for which they were ultimately reimbursed to the extent of the principal outlay. In addition, Messrs. Dupar and Thurston, two of the three payees, consistently throughout their testimony, referred to the disputed payments as being received by them in exchange for their services and undertakings. A further factor is that the landlord not only in 1931 but also at the time of the 1944 extension, insisted that they be maintained by taxpayer as its chief executive officers, which insistence was manifested in a specific lease covenant on the subject. The taxpayer agreed with the landlord in writing to maintain this personnel, and they in fact stayed on throughout the entire period involved in this case. Also before the Tax Court in support of its decision were the circumstances existing at the time of the 1944 extension. At that time the three payees, who still had two and a half years to go on their payments, acceded to a novation of the lease at an increased basic rental, which was understood to have priority over their own payments, even though there was grave con-

cern about the future because of predicted post-war depressions, the threat of serious competition, and the need for extensive capital outlays to rehabilitate the hotel which had badly run down during the war. In agreeing to this extension the payees regarded that from their personal standpoint they were foreclosing themselves from going into any other hotel ventures in the Portland area and that the extension committed them to stay with the Multnomah for an additional 15 years. Taken together, the evidence concerning the efforts and undertakings of the three payees on behalf of taxpayer, affirmatively sustains the ruling of the court below, which is made even more apparent in view of the principles of law under which such evidence must be evaluated.

4. The payments in question were not dividends and to so hold would require a strained and distorted interpretation of the facts. The appellant's argument in characterizing these payments as dividends is apparently based on two points, the first of which is in error on the facts, and the second a *non sequitur*. First, it is said that the payments were made in proportion to the stockholdings. This is manifestly not true, because Dupar, who owned less than 7% of taxpayer, negotiated for and secured 25% of the total payments in question, none of which was shared with minority stockholders. The latter were from time to time fiduciaries who cannot be presumed to have given up their right to demand a ratable share of any "dividend" that taxpayer paid. The second point is that the payments were negotiated so that the three payees would have a fixed or guaranteed return from the business. While an accu-

rate statement of fact insofar as it identifies one of the motivations for these payments it has no force as identifying the payments as dividends. Indeed, the idea of a fixed charge or payment is altogether consistent with the idea of compensation, but is inconsistent with its being a dividend, a dividend by definition being contingent upon earnings.

5. This arrangement was not made for the purpose of tax avoidance. It has a legitimate business purpose. Whatever the payees may have called the disputed payments, there can be no question that they were at all times paid—and thought of as being paid—in exchange for the services, efforts and undertakings of these individuals for and on behalf of the taxpayer. The record thus presented admits of no other conclusion than that the Tax Court's decision must be sustained.

## ARGUMENT

**1. The scope of review prescribed by statute and this court's own decision requires that the Tax Court findings be sustained unless they are clearly erroneous. The burden of proof is on appellant.**

A. The review of the Tax Court decision is to a large extent a factual rather than a legal problem, and for that reason as well as because of the references in appellant's brief to burden of proof, it would be advisable to set forth briefly the rules which govern the scope of review on appeal.

B. 26 USC 7482 vests in the Court of Appeals the exclusive jurisdiction to review the decisions of the Tax Court and establishes that this be done, “. . . in the same manner and to the same extent as decisions of

the District Courts in civil actions tried without a jury ; . . .”.

Supplementing this is Rule 52(a) Federal Rules of Civil Procedure which enjoins that findings of fact shall not be set aside unless clearly erroneous, “. . . and due regard shall be given to the opportunity of the trial court to judge the credibility of witnesses.”

This court has on several occasions examined these precepts. *Grace Bros. v. Commissioner of Internal Revenue*, 9 Cir. 173 F.2d 170; *Maloney, Collector of Internal Revenue v. Hammond*, 9 Cir. 176 F.2d 780; *Cohn v. Commissioner of Internal Revenue*, 9 Cir. 226 F.2d 22. In the *Maloney* case, *supra*, it said:

“On this question the trial court found in favor of appellee. In such a situation we have the duty of sustaining the findings of the trial court unless it is clearly erroneous.”

Even where the facts are stipulated as a substantial portion of them are in this case, this court will not disturb the findings of the Tax Court unless clearly erroneous, the reason being that stipulated facts are susceptible to inference and the lower court has the legitimate function of making such inferences. *Rollingwood Corp. v. Commissioner of Internal Revenue*, 9 Cir. 190 F.2d 263. The determination of whether a payment constitutes compensation for services, reasonable in the circumstances, is one of fact for the trial court. *Doernbecher Mfg. Co. v. Commissioner of Internal Revenue*, 9 Cir. 95 F.2d 296 *Vita-Food Corp. v. Commissioner of Internal Revenue*, 9 Cir. 238 F.2d 359; *J. H. Robinson Truck Lines v. Commissioner of Internal Revenue*, 5 Cir. 183 F.2d 739. The rule applies to



ultimate facts as well as evidentiary facts. *Burns v. Commissioner of Internal Revenue*, 177 F.2d 739.

Finally, and of signal importance in this proceeding is the well-settled rule that on appeal the *appellant* has the burden of proving that the Tax Court's findings are clearly erroneous and not supported by substantial evidence. *Grace Bros., Inc. v. Commissioner of Internal Revenue*, (*supra*).

**2. The Tax Court acted well within its authority in deciding this case on the grounds ascribed to the decision.**

A. Appellant argues that it was over-reached by the Tax Court, which on the review of the record held that the payments in question were deductible under Sec. 23(a)(1)(A) of the Internal Revenue Code of 1939 as compensation paid in the ordinary course of business. We think that this argument is specious for a number of reasons, but preliminarily it should be noted that neither in its motion for rehearing, amended motion or brief on appeal, did appellant give any suggestion of what evidence could be added to that already in the record to amplify the transactions in question. The clear implication of this is that appellant has no material additions to suggest which becomes even more clear upon examination of the record.

On an appeal from a decision of the Tax Court a similar contention was made by an unsuccessful litigant in *Anderson v. Commissioner of Internal Revenue*, 2 Cir. 156 F.2d 591. After reviewing the point at length, Judge Swan in his concurring opinion upheld the lower court stating the rule that:



“It is well settled that a decision may be sustained on a new legal theory where ‘no facts not already of record are required for decision. *Commissioner v. Hopkinsson*, 2 Cir. 126 F.2d 406, 409; *Alexander Sprunt & Son v. Commissioner*, 4 Cir. 64 F.2d 424, 427; *Helvering v. Gowran*, 302 U.S. 238, 246, 58 S.Ct. 154, 82 L.ed. 224.’”

In *Moore et al v. Commissioner of Internal Revenue*, 5 Cir. 202 F.2d 45, 47, the court analyzed a similar contention, but one in which the appellant (unlike appellant here) set forth additional facts it claimed it would prove if the record were reopened for additional evidence. The court upheld the trial court saying:

“We agree with respondent that the procedural point is without merit. This is because the time for petitioners to have made it was when the matter was first raised below. *It is because, too, the record as made below already contains all matter material to the issue. The five additional items of evidence which they say they can and will offer on rehearing are either already sufficiently disclosed in the record or are without real bearing on the determination of the issue.*” (Emphasis supplied)

In essence, the appellant’s point is that the Commissioner of Internal Revenue was denied the chance to put in new evidence, yet this contention is a naked ex-parte statement, unsupported by the slightest indication of what it could prove if the record were reopened, or what evidence there might be on this transaction other than that already reported. In the circumstances, the Tax Court, in a proper exercise of its discretion, denied the motion for rehearing, and by implication found no prejudice to appellant, which view is altogether supported by the present record.

B. The court can see that this record is unusually complete in all details of the transaction, including relationships, documents, motives, events and chronology. No documentary evidence that is material was omitted. The stipulation entered into between the parties covers the officer, director and stockholder relationships between the individuals and corporations in unusual detail. In addition, F. A. Dupar and S. W. Thurston appeared as witnesses at the trial and were exposed to a thorough cross-examination which consumed as many pages of the record as the direct. In fact, it was during this cross-examination that a good deal of the evidence in support of the Tax Court's ruling was developed (R. 117, 134, 137, 139).

This court should note particularly that counsel for the Commissioner of Internal Revenue offered no objection or reserved no exception to the admission of detailed testimony of Messrs. Dupar and Thurston regarding the amount of work done by the three "payees," their motivation for demanding these payments, their undertakings, their chances of success, their risks, or the fact that they considered the money to be a return for their personal efforts, all of which testimony supports the decision of the Tax Court.

The record discloses, in the testimony of Messrs. Dupar and Thurston, that the payments received from Multnomah were consistently regarded and described as being earned payments for their work and services in the Multnomah Hotel venture (R. 102, 106, 131, 132, 134, 137). Prior to the original lease, Maltby, PCI and Dupar negotiated continuously for between ten months

and a year before the deal was closed (R. 100), and during that time approximately twenty trips were made by them from Seattle to Portland (R. 100), these trips taking up to two days each. All three negotiated actively and their labors were approximately equal (R. 117, 118). The venture was undertaken in a period of great uncertainty, when the hotel was in extremely bad financial condition (R. 105) and when the property was badly run down and needed large outlays of capital for rehabilitating it (R. 99, 106). There was thought to be great risk in the venture (R. 124), both at the time of the original lease (R. 105) and of the 1944 extension (R. 111). At the time of the 1944 extension, these individuals had two and one-half years to go before their payments ran out; yet they agreed to the extension, even though it increased the basic lease rental to \$8,500.00 a month, which had priority over their payments, and was made at a time when serious concern existed over post-war conditions, due to predicted depressions (R. 107), the prospect of serious competition (R. 111), and the need to spend a large sum of money to rehabilitate the hotel, which had run down because of war-time material and labor restrictions (R. 108).

In addition to the work done and risk involved in negotiating the Multnomah lease and its extension, Dupar, PCI and Maltby were required to guarantee the original leasehold obligations of taxpayer (R. 129, 130), under an arrangement wherein \$75,000.00 of preferred stock in Maltby was bought by them and advanced to taxpayer to secure performance of their lease.

These individuals had had long experience as hotel

operators and the owner of the building considered that "... the personnel factor governed the deal" (R. 129). In the original lease it was recited that the lease "is to a large extent based upon the personnel of the present officers of said lessee," and that "it is understood and agreed that the within lessee contemplates the forming of an Oregon corporation to whom the within lease may be assigned by it, the majority of the personnel of which will be the same as that of the within named lessee and/or Western Hotels, Inc., . . .". The same provision governed the 1944 extension, as is evidenced by Exhibit 5 (R. 92), and the testimony of the witnesses during the trial (R. 129). Witness Dupar testified that, viewed from their personal standpoint, they "were signing up with the Hausers for another fifteen years and that (they) would have to stay with them and not get into negotiations on a new hotel with other people" (R. 112).

At page 106 of the record, it was stated:

"Q. Did you consider that your services in connection with the negotiations of that lease justified the payment which was required?

A. Yes, I did.

Q. Did you have in mind any questions of the effect tax-wise upon Multnomah Operating Company?

A. Taxes were a very small matter in those days. I don't remember what the tax rate was, but I don't think it was over ten per cent."

There was thorough examination and cross-examination of the witnesses on all of these points and it is difficult to visualize how any amplification could be mate-



rial, particularly since the inquiry here is limited to whether the findings of the Tax Court are sustained by substantial evidence, rather than whether taxpayer has met his burden of proof.

C. In *Anderson v. Commissioner of Internal Revenue*, (*supra*), the test invoked to determine whether the Tax Court went beyond its authority was whether its decision was based on facts *other than those which appear in the record*. This test would seem particularly applicable here, where the record is complete, where the evidence supporting the trial court's decision was admitted without objection, where full cross-examination was made and where the appellant is unwilling or unable to point out how the record could be amplified.

Standing in contradistinction is the case of *Standard Galvanizing Company v. Commissioner of Internal Revenue*, 7 Cir. 202, F.2d 736, quoted in part and relied on by appellant, wherein the Circuit Court reversed and remanded a case to the Tax Court. There the Tax Court had examined whether an item of attorneys' fees was deductible as being a necessary expense incurred in the ordinary course of business. The fees were incurred in litigating the case of an officer who had pledged personal securities to obtain a loan for the taxpayer and who was subsequently sued on the debt. The question presented to the Tax Court was whether the taxpayer was required to enter into this litigation by virtue of the fact that the officer had acted on behalf of the taxpayer in procuring the loan. Although the theory was thus based on contract, and although there was no evidence whatsoever on the question, the Tax



Court disallowed deduction on the gratuitous theory that the officer had been *negligent*, which negligence exonerated the taxpayer.

The exact opposite is present in this case, because the court had before it a full record in which the payments to Maltby, Dupar and PCI were repeatedly identified as payments made in exchange for their services in negotiating the hotel lease and its extension and their other undertakings in regard to the lease and operation of the hotel properties.

D. Moreover, an analysis of this case shows that the appellant is incorrect in its basic assumption that the Tax Court "injected a new issue" in the case when it held that Multnomah was entitled to deduct the Dupar, Maltby and PCI payments as compensation under Sec. 23(a)(1)(A). The law which the Tax Court has applied is the same section of the Internal Revenue Code that was relied upon by taxpayer throughout. The identical activities by Dupar, Maltby and PCI with regard to negotiating the hotel lease and performing other services, gave rise to both the claim by the Multnomah that the payments were a proper deduction against its income tax as a business expense, and the holding by the Tax Court that the Multnomah should be allowed to deduct them as a business expense. The money payments held to be deductible were the same as those claimed by the taxpayer as a deduction. No new amounts were involved. The same tax years and the same persons were involved throughout.

In identifying the payments as *rent* payments for services rather than *compensation* payments for serv-

ices, the taxpayer does nothing to change the fact that they were payments for services and that fact is what creates and controls the taxable event as the Tax Court held below. It seems to us that appellant is making a purely semantical argument in its use of expressions such as "injected a new theory in the case." To illustrate this further we point out that the situation here is not like that presented in *Standard Galvanizing Company v. Commissioner of Internal Revenue*, (*supra*), on which appellant relies, where the issue raised was that of a contractual relationship and where the decision was based on a theory of negligence arising out of collateral facts not even in evidence.

It is well settled that a taxpayer cannot establish or alter the tax consequences of a given transaction by merely using a name. *Commissioner of Internal Revenue v. Schmoll Fils Associated*, 2 Cir. 110 F.2d 611; *Jewell Tea Co. v. U.S.*, 2 Cir. 90 F.2d 451; *U.S. v. Southern Georgia Railway Company*, 5 Cir. 107 F.2d 3; *Jordan Co. v. Allen*, USDC Ga. 85 F.Supp. 437.

E. According to our research it is in any event settled law that an appellate court has the power to apply any theory supported by the record to sustain a lower court's decision where the lower court reached a correct result under the facts of the case. *Hormell v. Helvering*, 312 U.S. 552, 61 S.Ct. 718, 85 L.ed. 1037; *Rhodes v. Commissioner of Internal Revenue*, 111 F.2d 53; *Helvering v. Gowran*, 302 U.S. 238, 58 S.Ct. 154, 82 L.ed. 224. In the *Rhodes* case, *supra*, the Court of Appeals for the 4th Circuit stated the rule in a very thorough opinion as follows:

“This latter rule seems to be that an appellee may urge or the appellant court on its own motion may consider any theory, argument or reason in support of a decision of a lower court or board irrespective of whether or not such theory, argument or reason was relied upon or even considered by or suggested to the court below. . . .”

It would be manifestly improper to disturb the findings of the Tax Court, when appellant cannot point out how the record is incomplete, where he had ample chance to cross-examine the witnesses on all points presented, where testimony in support of the Tax Court decision was admitted without objection, where the record as it stands is unusually complete, where the Tax Court patently based its decision on facts of record, and where the decision did not in fact raise any novel issue.

**3. There is substantial and compelling evidence to sustain the Tax Court finding that the payments in question to Dupar, Maltby and PCI were reasonable compensation for their service.**

The analysis under this heading is primarily a factual analysis, because the only question before the court is that of determining whether the decision of the Tax Court is supported by substantial evidence insofar as it found that the disputed payments to Maltby, Dupar and PCI, by taxpayer, were compensation for services rendered. The Tax Court had before it an unusually complete and detailed record of the labors of these three in securing the original lease and its 1944 extension, of their efforts in organizing the hotel venture, of their

guaranteeing the performance of the original lease covenants, of their remaining as executive personnel of taxpayer corporation throughout at the insistence of the landlord, of the conditions and adversities that faced them both in 1931 and 1944, of their successful development of the business, and other evidence which clearly sustains the decision of the Tax Court.

After review of this record, the Tax Court found :

“ . . . In the light of the testimony of Dupar and S. W. Thurston, who represented Maltby in all the transactions here involved, it is clear that the basis for the payments was services rendered by the three payees prior to execution of the original lease in 1931, and also prior to the execution of the renewal agreement in 1944, and for services to be rendered thereafter during the terms of the lease and its renewal. . . . ” (R. 46)

It is now the position of appellant that this finding was arbitrary and capricious, and in any event not supported by substantial evidence. We submit that the record is such that it affirmatively shows the Tax Court to be correct, let alone supplying the substantial evidence which renders the lower court's findings inviolate.

A. In the first place, the record shows that in the period 1930-1931 when this venture was undertaken, Maltby, Dupar, and PCI expended an enormous amount of work and effort in securing possession of the property. This work was not confined to a lease negotiation, but actually embraced the development of an important hotel business at a time when the national economy was declining into the depression of the 1930's and also at a time when the hotel was badly run down



and losing money. The atmosphere was one of great concern over the high risk involved.

Mr. Dupar testified at pages 105, 106 of the record:

“Q. With respect to Multnomah Operating Company as of 1931, what was your then anticipate of the earning prospects of the company?”

A. Well, we really didn’t expect to get all our lease rent.

Q. Pardon me?

A. I say, we did not expect to get the \$30,000.00 even, we didn’t think it would make that much.

Q Why was that?

A. Well, as I say, we were in the depression and it was getting worse every day. Our business was going down, our volume was going down. That continued for, well, right into ’32.

Q. Well, what was the condition of the property as to its requirements with respect to maintenance?

A. It was in a very dilapidated condition. The lobby was just shameful, I thought. The rooms upstairs were perhaps 250 without baths. The furniture was old, the carpets were old, it needed a great deal of work, a great deal of money spent on it.”

The negotiation was carried on by Mr. Dupar, Mr. Peter G. Schmidt (representing PCI) and Mr. S. W. Thurston (representing Maltby), for a period of time extending over ten months to a year (R. 100, 128), all three constantly traveled from Seattle, Washington, to Portland, Oregon. Witness Dupar testified that in doing this they went down twenty-five times (R. 100) which is corroborated by the testimony of S. W. Thurston, who recollected having had between “twenty and



thirty” meetings which lasted from “half a day to two or three days” (R. 128). Their labors were approximately equal (R. 117, 118). As a result of these efforts the Multnomah lease was eventually secured from Hauser Securities Company, the building owner, and taxpayer went into possession of the hotel. The hotel was eventually developed into a prosperous business (R. 11) through the continued efforts of the payees, as officers and directors of taxpayer.

We submit that on the basis of hindsight, which seems to be the basis which the Commissioner has repeatedly used in viewing this transaction, the above facts alone would support a much higher compensation than was in fact paid to Maltby, PCI and Dupar. In this connection we cannot resist quoting from Regulation 111 insofar as it sets out an express injunction to evaluate arrangements such as this from the circumstances as they existed when the contract was made rather than the circumstances present when the contract is challenged.

“ . . . The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date the contract is questioned.” Reg. 111, Sec. 29.23 (a)-6(3).

B. In addition to securing the property and organizing the venture, Dupar, PCI and Maltby, on behalf of Multnomah, agreed to pledge their personal credit up to \$75,000.00 to guarantee the taxpayer’s performance of the lease covenants. On this point the Tax Court found (R. 41):

“The lessor required the deposit of security for

the performance by petitioner of the lease provisions. To that end Maltby issued to petitioner \$75,000.00 of its preferred stock, which petitioner agreed to purchase. Petitioner in turn deposited the stock as security with the lessor. PCI through its trustee, Peter G. Schmidt, and Frank Dupar, each guaranteed to Maltby in writing that petitioner would pay the par value of 25% of such stock. Each was required at an undisclosed time to pay the amount so guaranteed for which payment each was substantially reimbursed by petitioner."

The testimony of F. A. Dupar on this subject appears on page 105 and 106 of the record. Witness Thurston described this arrangement as follows (R. 129) :

"Q. Aside from the provisions of the lease itself, was there any requirement for the giving of security to the Hauser Securities Company?

A. There were seventy-five or seven hundred fifty shares of Maltby-Thurston preferred stock, it was put up by a security that was considered at that time to be worth \$75,000.00.

Q. That was to be forfeited as liquidated damages in the event this lease was not carried out in accordance with its terms?

A. Correct.

Q. Who put that stock up?

A. Maltby-Thurston, half of it, half of it was put up by interests, Frank Dupar, including himself, the chief interested party, or a quarter, I mean, and a quarter by Peter Schmidt and the Pacific Coast Investment Company in their side of the picture.

Q. The stock was actually put up by your company, was it not, and they in effect guaranteed you against any loss, is that right?

A. Dupar interests and Schmidt Maltby-Thurston Company against loss of the quarter interest each that they had.

Q. Did they later make good on that guarantee?

A. They did. It was paid."

This guarantee of taxpayer's obligation by stockholders must also be considered in the light of the circumstances then existing to evaluate properly the scope of the undertaking. Multnomah had nine stockholders at the time (R. 26), but the guarantee was made by three of them, Maltby, Dupar and PCI. The amount was a very substantial sum in those days, particularly since the Maltby operation was one of great risk (R. 105, 106), and since Dupar himself "needed money as bad as anybody at that time" (R. 106), and Maltby was "in serious financial trouble, as good corporations were in 1931" (R. 102). In the circumstances the offering of the guarantee to taxpayer was a very valuable and substantial service, completely consistent with the Tax Court finding that Maltby, PCI and Dupar rendered and were compensated for their services and undertakings. It is on the other hand a factor most hard to reconcile with the Commissioner's analysis that the Multnomah's payments are distributions of profits, which they clearly were not.

C. Although sometimes referred to as rental payments for their services (R. 134, 135),<sup>2</sup> the court should

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<sup>2</sup>The court should note that even during the trial there was a demonstrated uncertainty over nomenclature (although none whatever over the fact that the payments were regarded by the payees as an exchange for their services and undertaking). At record 134 Mr. Thurston testified, "A. I don't know how you would construe it. It was a lease between Multnomah Operating Company that required that payment. I don't know how you would refer to it unless it would be as a rental."

particularly note that witnesses Dupar and Thurston consistently and repeatedly testified that they thought of the payments as an earned exchange for the efforts, work and undertaking of the three payees in the Multnomah Hotel venture (R. 102, 106, 131, 132, 134, 137). At record 47 the Tax Court correctly observed:

“We are impressed, however, that this record fully substantiates the conclusion that whatever the petitioner has named the amount sought to be deducted, they were compensation for services rendered in the ordinary course of petitioner’s business within the meaning of Sec. 23(a)(1)(A) . . . ”

By way of illustrating this point, it is pointed out that witness Thurston, the representative of one of the three payees of the disputed sums, testified (R. 131) :

“Q. Can you state whether or not that payment represented a fair compensation for the services and liability and responsibility which was involved?

A. We felt it did at that time.”

Further, he said in answer to a question on cross-examination as to how the division of payments was arrived at (R. 137) :

“Q. Isn’t it correct that fifty per cent paid to Maltby-Thurston Hotels, Incorporated, and the twenty-five per cent paid to Peter Schmidt as trustee, were based on stockholdings in the petitioner?

A. I don’t recall having any agreement to that effect and I don’t know that it was to that effect. I believe that it was predicated a great deal upon the services rendered. I know Mr. Dupar and my-

self and Mr. Schmidt in person rendered a great deal of services in these cases.”

On direct examination, Mr. F. A. Dupar testified (R. 106):

“Q. Did you consider that your services in connection with the negotiation of that lease justified the payment which was required?

A. Yes, I did.

Q. Did you have in mind any questions of the effect taxwise upon Multnomah Operating Company?

A. Taxes were a very small matter in those days. I don't remember what the tax rate was, but I don't think it was over 10%.”

He further testified at page 102 of the record:

“ . . . My position was that I had very little of the stock. I was just a minority stockholder. I had done all the work, I was entitled to something, and I hung out for a lease that would pay me something.

THE COURT: You had done all what work?

THE WITNESS: Negotiating the, negotiating the lease with the Hausers which took several months.”

Also in regard to the situation in 1944 when the three payees consented to go along with the extension of the hotel lease, Dupar testified (R. 111):

“Q. In 1944 when you made your commitment on the basis of the extended lease, did you feel that you were in any way prejudicing your personal position by continuing the arrangement, that is, that the participants were?

A. We felt that we had, we were signing up with the Hausers for another 15 years and that we



would have to stay with them and not get into negotiations on a new hotel with other people.”

The payments made by taxpayer were clearly regarded by them as exchange for what they had done as individuals, and this fact is very significant in this review because the concept of payment for services is entirely consistent with the findings of the Tax Court, whereas it is entirely inconsistent with the Commissioner's theory that they were dividends. Appellant attaches some importance to the fact that witnesses Dupar and Thurston, although laymen, identified the returns for their efforts as rents, but it is respectfully submitted that to the extent they did employ the expression “rental,” their entire testimony about insisting on the payments in exchange for services is greatly enhanced in credibility, as there could have been no subjective predisposition by the witnesses to substantiate them as salaries. Such considerations as this are the distinct province of the Tax Court in evaluating witnesses before it. Rule 52(a) Federal Rules of Civil Procedure.

D. Also giving credence to the Tax Court decision is the fact that the taxpayer was required to and did maintain the three payees on its staff as principal executive officers during all times involved in this action. Dupar and Thurston, representing Maltby, and Schmidt, representing PCI, occupied the chief executive posts in Multnomah through the entire period 1931 to 1949, except that in the 1940's F. M. Kenney replaced Schmidt as the representative of PCI, he having taken over the Presidency of that corporation (R. 35, 36, 37). This fact was not disputed by the Commissioner.

Both at the time of the original lease and the 1944 extension agreement, Hauser Securities Company, the owner of the hotel property, insisted that they be kept on, and this insistence was imposed as a condition to turning the hotel over to Multnomah (R. 128, 129). It was even carried to the point of being written into the lease as a lease covenant (Ex. 1, R. 72), which this court will agree is an unusual manifestation of concern on the point, viewed from the standpoint of how businessmen normally arrange such affairs. The situation in this regard is well illustrated by the testimony of Mr. Thurston (R. 129):

“Q. Did the Hausers make any requirements in that respect?

A. They did very definitely, and I believe it was written into the lease, if I remember right, that the same personnel must be maintained, and the lease was taken by the Maltby-Thurston Company and transferred into an operating company, and in that operating, or in that assignment was a definite condition that we had to maintain the personnel and the contacts.”

This is supported by Mr. Dupar, who in describing the situation in 1944, said (R. 111):

“A. Eric Hauser, who represented the owners in most of the negotiations, was very particular on the point of who was going to run the hotel. He said as long as the Western, the same personnel as is now in the Western, run, own and operate the Multnomah Hotel, he was willing to give us this extension. And I think if we transferred to another corporation that the lease could be validated or made invalid.”

The taxpayer expressly assumed the lease covenant

regarding maintenance of the same personnel, in both the instruments assigning to it the original lease (R. 78), and the 1944 extension, and recognized it as a legal obligation in the written contract which extended the payments in question to the three payees (Ex. 5, R. 92). The 1944 extension (Ex. 3, R. 81) was actually a novation of the lease and ran directly to taxpayer without any intervening assignment; and in such form imposed the personnel requirement directly on taxpayer (R. 85).

Although collateral to the issue, we wish to point out that the Commissioner has attempted to minimize the significance of this personnel requirement as evidence of the contribution by the three payees to Multnomah by arguing that they were not the persons Hauser Securities Company had in mind, the Commissioner's theory being that the lease covenants provided that the Multnomah be staffed by the principal personnel of Western and Maltby, rather than the three payees identified by name. It should be noted that the three payees were actually the President, Vice-President and Secretary, respectively, of Western (R. 37) throughout the entire period involved in this case, and, with the exception of Schmidt, they were also the chief executive officers of Maltby, which added to the fact that for 17 years Hauser claimed no dissatisfaction with the arrangement would seem to remove any question as to whether they were the operating personnel the landlord had specified.

The important point to be kept in mind in evaluating the contribution of the three payees to taxpayer, is that they procured the lease and organized the hotel busi-

ness at a time when the hotel was physically and financially run down, and over a period of years thereafter developed it into a sound and prosperous business (R. 10, 11). The owner's agreement to lease was at all times based upon their "ability to conduct and operate a first-class hotel" (R. 84), which he believed would reflect itself in increased rentals under the percentage rent arrangement. At the time of the original lease the three payees were experienced hotel operators (R. 99), and at the time of the lease extension in 1944, they brought to Multnomah and the owner an additional 13 years' experience of successful operations in the Multnomah Hotel itself.

There is a related consideration which the Tax Court could legitimately consider in its evaluation of these services. Hauser Securities Company insisted on having them and bargained for them at arm's length as a complete stranger to the transaction, which lends great weight to the finding that the services were in fact an important contribution to taxpayer. In view of the value of the Multnomah Hotel as a going business (which is evidenced by the fact that even in the 1930's it supported a basic rent of \$7,000.00 per month (R. 70)),<sup>3</sup> it is utterly ridiculous to say—as the appellant seems to argue—that the amounts set out at R. 19, 20, constitute an adequate compensation to the three payees unless supplemented by the payments here in question. Even then, the compensation is modest by any reasonable standards.

E. A further line of evidence in support of the Tax

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<sup>3</sup>See also R. 11 where in 1948 the net income before taxes was reported at \$267,938.63.



Court finding in this case is the situation that existed at the time the 1944 extension was negotiated. These negotiations were carried out over a period of four years with the active participation of Dupar and Thurston (R. 107, 108). The new lease was granted on the express condition that the taxpayer maintain the same operating personnel as before. The three payees agreed to the extension (Ex. 5, R. 97) which included a substantially increased basic rent for the building, even though they had two and a half years to run on their own payments, which were generally understood to be subordinated to the basic lease rental. The situation at the time was one of grave and legitimate concern about the future of the business, because of predicted post-war depression (R. 107), a threat of serious competition (R. 111), and the need for very heavy expenditures to rehabilitate the hotel which had run down during the war years because of labor and material restrictions (R. 108). With these prospects before them, they considered that they had foreclosed themselves from going into any other hotel ventures in the Portland area by signing this extension, which is illustrated by the testimony of Mr. Dupar at page 111. In answer to the question of whether their commitment in any way prejudiced their personal position he said:

“A. We felt that we had, we were signing up with the Hausers for another 15 years and that we would have to stay with them and not get into negotiations on a new hotel with other people.”

Taken altogether, there is an abundance of evidence regarding (a) the efforts of the three payees at the time of the original lease, (b) their personal guarantees



and undertakings, (c) their continuous reference to these payments as a return for services, (d) their position as key men in the organization, (e) their efforts, undertakings and concessions in regard to the 1944 extension, (f) their experience and ability, and (g) their personal risk under the circumstances apparent at the time the payments were established.

We respectfully submit that the Tax Court decision is completely supported by this record, and under the limited question before this court—whether or not there is substantial evidence—the Tax Court decision must stand.<sup>4</sup>

**4. The Tax Court found that the payments in question were not paid or received as dividends, and that finding is justified by compelling evidence.**

To find that these payments constitute dividends requires a strained and unnatural interpretation of the evidence. Indeed, the entire theory of the Commissioner on this point (See pages 24-27 of appellant's brief),

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<sup>4</sup>Although primarily a factual question, the result is even more clearly indicated in the light of the legal principles which guide the analysis, including the following: (a) The determination of whether payments constitute compensation for services, reasonable in amount, is a fact question for the trial court. *Doernbecher Mfg. Co. v. Commissioner of Internal Revenue*, 95 F.2d 296; (b) It is proper for a taxpayer to allow compensation for services which were rendered in the past. *Lucas v. Ox Fibre Company*, 281 U.S. 115, 50 S.Ct. 273, 74 L.ed. 733; (c) where services are rendered to the taxpayer it is immaterial that the payments are made to stockholders, even where made in proportion to stockholdings (which is not the case here). *U. S. v. Reitmeyer*, 11 F.2d 648; (d) the situation must always be evaluated from the point of view of circumstances as they exist when the contract for payments was set up. Reg. 111, Sec. 29.23(a)-6(3); (e) the experience of those performing services has long been recognized as a factor in evaluating the reasonableness of what has been paid to them; (f) the factor of risk and uncertainty is also entitled to great weight in such evaluation. *Commercial Iron Works v. Commissioner of Internal Revenue* (5 Cir.) 166 F.2d 221.

boils down to two arguments, one of which is an erroneous statement of the facts, and the other a *non sequitur*.

A. It is first urged that the disputed payments were given in proportion to the stockholdings of the payees. Of course, this in and of itself does not make payments dividends, *United States v. Reitmeyer*, 11 F.2d 648, but even if it did the record clearly shows that Dupar, who owned less than a 7% interest in taxpayer corporation (R. 26), negotiated for and received personal payments equal to 25% of the total paid, none of which he shared with other minority stockholders (R. 105). It is important to note that the balance of these minority shares were owned at various times and in varying amounts by fiduciaries for decedents' estates and trustees (R. 26), none of whom received any portion of the payments here in question. One of these fiduciaries was Seattle-First National Bank as Trustee under the will of H. E. Dupar, deceased, an organization that cannot be presumed to have surrendered its prerogative to receive a proportionate part of any payments distributed by taxpayer as a dividend.

The stockholdings of the three payees in Western cannot be substituted for their stockholdings in taxpayer corporation, as appellant seeks to do, because Western was neither a parent nor a subsidiary, and none of the disputed payments were ever made to Western which got its compensation in the form of fees that are in no way involved in this case. So far as Maltby is concerned, appellant makes no such analogy, because in that case it would not work to the Commissioner's

advantage, Dupar having no stock ownership whatever until late in this period of events when he picked up small lots aggregating less than 4% of the total.

These payments were therefore not in proportion to the stockholdings of the payees, it being submitted that even if they were it would still not justify the Commissioner's contention that the payments were dividends under the facts of this case and the applicable law.

B. The Commissioner's second point is that the payments were demanded by the three payees so that they would be guaranteed a fixed return from the business to them as individuals. This fact is, of course, correct insofar as it shows the motivation of the payees who feared both at the time of the 1931 agreement and the 1944 extension that high expenditures would be required to rehabilitate the hotel and meet economic adversity (R. 102), and in the case of Dupar, that control over these expenditures would be reposed in the hands of two former bitter competitors who owned almost three-quarters of the stock between them. We fail to see how setting up these payments as a fixed charge in any way converts them into dividends or in any way alters the fact that they were demanded by reason of the efforts and undertakings of the payees in the Multnomah Hotel operation. Indeed, a contract to pay compensation *for services* is a fixed charge under any acceptable legal or accounting theory, but a dividend by its very definition is not. It must be constantly kept in mind, both as bearing on this question and as illustrating that the payments were set up by persons having antagonistic and dissimilar interests, that in 1931 when

the original lease was secured, the three payees had been "three very bitter competitors" (R. 98), two of whom were in a minority position. Because of the run-down condition of the hotel and need to rehabilitate it before it could be successfully operated, each of the minority shareholders faced an absolute control over expenditures by individuals who were his recent competitors, and this fact explains the insistence on having these payments; but we fail to see how it has any logical relation to the Commissioner's contention that it characterizes them as dividends.

### CONCLUSION

The payments here in question have been made by the petitioner since the year 1931. They were continuously paid for a period of some 17 years before challenged by the respondent. While we recognize that the failure of the respondent to challenge the payments in previous years is not a bar to a later challenge, as in this instance, nevertheless it is indicative that so far as the Commissioner was concerned the payments were not such as to historically cause concern for their validity.

In practically every case where the Commissioner has been sustained in challenging payments, as non-deductible dividends, the circumstances have been such as to show that the payments made were essentially a plan or device for the purpose of avoiding taxes, which clearly is not the case here, under the testimony of Mr. Dupar that taxes were not even a factor when they were set up (R. 106), and in view of the clear and cogent evidence that they were received for the efforts and undertakings of the payees in setting up the original hotel operation and the 1944 extension.

Under the scope of review prescribed by this court's own decisions, the issue is in any event limited to determining whether the Tax Court was clearly erroneous, and on this subject the appellant has the burden of proof. By any reasonable standards the evidence in this unusually complete record not only supports the findings below in the sense of providing "substantial evidence," but affirmatively and compellingly demonstrates that the decision of the Tax Court was correct.

HARRY HENKE, JR.

WM. E. EVENSON

PAUL W. STEERE

*Attorneys for Respondent.*

1001 Dexter Horton Building,  
Seattle 4, Washington.  
April 26, 1957.





No. 15371

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United States  
Court of Appeals  
for the Ninth Circuit

---

IRMGARD SANTOS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

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Transcript of Record

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Petition to Review a Decision of The Tax Court  
of the United States.

FILED

FEB 15 1957

PAUL P. O'BRIEN, CLERK



No. 15371

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United States  
Court of Appeals  
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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The Tax Court of the United States

Docket No. 46327

IRMGARD SANTOS,

Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

## AMENDED PETITION

\* \* \* \* \*

Form 1235-A .

Treasury Department, Internal Revenue Service,  
P.O. Box 421, Honolulu 9, Hawaii

Office of Internal Revenue Agent in Charge, Honolulu Division, 560 Alexander Young Building.

In Replying Refer to: FC: IMJ-150D

Oct. 15, 1952

Mrs. Irmgard Santos, Transferee  
1051 Fort Street, Honolulu, Hawaii.

Dear Madame:

You are advised that the determination of the income tax liability of Lawrence Santos, Transferor, 1051 Fort Street, Honolulu, Hawaii for the taxable years ended December 31, 1943, December 31, 1944, December 31, 1945, and December 31, 1946, discloses a deficiency of \$808,088.93 in income tax and penalties, as shown in the statement attached. \$68,287.90 of the amount of the deficiency

in income tax and penalties, plus interest as provided by law, constituting your liability as transferee of assets of said Lawrence Santos, has been assessed against you under the provisions of the internal revenue laws applicable to jeopardy assessments.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 150 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 150 days you may not exclude any day unless the 150 day is a Saturday, Sunday or legal holiday in the District of Columbia in which event that day is not counted as the 150th day. Otherwise Saturdays, Sundays and legal holidays are to be counted in computing the 150-day period.

Very truly yours,

JOHN B. DUNLAP,  
Commissioner,

By H. A. PETERSON,  
Internal Revenue Agent in Charge

Enclosure: Statement Form 1276

## STATEMENT

Lawrence Santos, Transferor, 1051 Fort Street,  
Honolulu, Hawaii

Tax liability for taxable years ended December 31,  
1943, December 31, 1944, December 31, 1945,  
and December 31, 1946.

Mrs. Irmgard Santos, Transferee,  
1051 Fort Street, Honolulu, Hawaii

## LIABILITY

Year	Income Tax	Penalties	Total
1943	\$177,847.27	\$197,049.35	\$374,896.62
1944	\$163,935.11	\$ 81,967.56	\$245,902.67
1945	\$105,588.98	\$ 53,007.08	\$158,596.06
1946	\$ 28,693.58	\$	\$ 28,693.58
Totals	\$476,064.94	\$332,023.99	\$808,088.93

Liability limited to value of assets received:

Income Tax .....\$68,287.90

Inasmuch as the value of assets received by you amounted to \$68,287.90, your liability as transferee is limited to that amount. This liability is applied to the year 1945.

In making the determination of the income tax liability of Lawrence Santos, transferor, careful consideration has been given to the reports of examination dated February 5, 1947 and September 26, 1949; to protests dated January 9, 1950 and October 13, 1951; and to statements made at conferences held on January 10, 1952, and January 30, 1952.

A copy of this letter and statement has been mailed to your representatives, Cameron, Tennent & Dunn, P. O. Box 3556, Honolulu 11, Hawaii, in accordance with the authority contained in the power of attorney executed by you.

The income Tax Liability of Lawrence Santos, transferor, has been computed as follows:

## TAXABLE YEAR ENDED DECEMBER 31, 1942

## ADJUSTMENTS TO NET INCOME

Net income as disclosed by amended return.....	\$128,684.81
Unallowable deductions and additional income:	
(a) Dividends .....	\$ 11.97
(b) Interest income .....	75.84
(c) Rents .....	225.00
(d) Capital gains .....	2,068.08
(e) Other income .....	24,516.39
(f) Interest expense .....	300.56
	<hr/> 27,197.84
Total.....	\$155,882.65
Nontaxable income and additional deductions:	
(g) Income from business .....	\$104,044.67
	<hr/>
Net income adjusted .....	\$ 51,837.98

## EXPLANATION OF ADJUSTMENTS

(a) You omitted from your return net dividend income in the amount shown.

(b) You failed to include in your return interest received in the amount shown.

(c) You omitted rental income from the U. S. Army in the amount shown.

(d) You reported a capital gain of \$8,134.78 from the receipt of liquidating dividends on stock of Persan's Ltd., whereas the actual gain was \$10,202.86 computed as follows:

Liquidating dividend received as of 12/31/42.....	\$ 32,826.94
Cost of 1,790 shares .....	\$ 17,900.00
	<hr/>
Gain .....	\$ 14,926.94
	<hr/>
Gain on stock held six months or less.....	\$ 5,478.77
Gain on stock held over six months.....	\$9,448.17
50% taxable .....	\$ 4,724.09
	<hr/>
Total .....	\$ 10,202.86

(e) Unidentified deposits totalling \$24,516.39, which constitute taxable income were omitted from your return.



(f) You overstated interest paid to Arthur G. Faria in the amount of \$300.56.

(g) You erroneously included income in the amount of \$104,-044.67, which is taxable to Persan's Ltd.

### COMPUTATION OF ALTERNATIVE TAX

Net income adjusted .....	\$51,837.98	
Minus: Excess of net long-term capital gain		
Over net short-term capital loss .....	\$ 4,724.09	
Ordinary net income .....	\$47,113.89	
Less: Personal exemption .....	\$1,200.00	
Credit for dependents .....	\$ 700.00	\$ 1,900.00
Balance (surtax net income) .....	\$45,213.89	
Less: Earned income credit—maximum.....	\$ 1,400.00	
Balance subject to normal tax.....	\$43,813.89	
Normal tax at 6% .....	\$ 2,628.83	
Surtax on \$45,213.89 .....	\$20,224.75	
Partial tax .....	\$22,853.58	
Plus: 50% of \$4,724.09 .....	\$ 2,362.05	
Alternative tax .....	\$25,215.63	

### COMPUTATION OF TAX

Net income adjusted .....	\$51,837.98	
Less: Personal exemption .....	\$1,200.00	
Credit for dependents .....	\$ 700.00	1,900.00
Surtax net income .....	\$49,937.98	
Less: Earned income credit.....	1,400.00	
Balance subject to normal tax.....	\$48,537.98	
Normal tax at 6% .....	\$ 2,912.28	
Surtax on \$49,937.98 .....	23,200.93	
Total normal tax and surtax.....	\$26,113.21	
Correct income tax liability (alternative tax).....	\$25,215.63	

## TAXABLE YEAR ENDED DECEMBER 31, 1943

	Income Tax Net Income	Victory Tax Net Income
Net income as disclosed by return	No return filed	
Unallowable deductions and additional income:		
(a) Commissions .....	\$ 141.86	\$ 141.86
(b) Dividends .....	1,189.02	1,189.02
(c) Interest .....	577.69	577.69
(d) Capital gain .....	8,646.38	.....
(e) Gain from sale of property other than capital assets .....	123.66	123.66
(f) Rental income .....	360.00	360.00
(g) Income from business .....	154,490.31	154,490.00
(h) Other income .....	191,941.83	191,941.83
Total.....	\$357,470.75	\$348,824.37
Nontaxable income and additional deductions:		
(i) Contributions .....	\$ 1,194.00	.....
(j) Taxes .....	4,825.47	.....
Total.....	\$ 6,019.47	None
Net income adjusted .....	\$351,451.28	\$348,824.37

## EXPLANATION OF ADJUSTMENTS

No return was filed for the year ended December 31, 1943. Adjustments shown in this statement are substantially based on your books and records.

(a) Trustee's commissions of \$141.86 were received by you from the Estate of Arthur G. Faria.

(b) You received dividends in the amount shown, which constitute taxable income.

(c) Interest income in the amount of \$577.69 was received by you.

(d) The following capital gain was found to be taxable to you during 1943:

Liquidating dividend from Persan's Ltd.....	\$13,021.40
Cost of 710 shares on 1/12/43.....	4,375.02
Short-term capital gain .....	\$ 8,646.38

(e) A taxable gain resulted from the sale of property as follows:

Fixtures acquired from Persan's Ltd.:	
Cost 12/31/42 .....	\$ 2,007.22
Sold on 6/15/43 for .....	2,130.88
<hr/>	
Gain .....	\$ 123.66
<hr/>	

(f) Rental income of \$360.00 was received from the U. S. Army for a lease on property at Haleiwa, Oahu.

(g) Income from your business, known as Manufacturer's Shoe Store, was found to be \$154,490.31, as compared to income per your books of \$103,233.01, based on the following adjustments:

Net income per books .....	\$103,233.01
Additions:	
(1) Gross sales .....	21,583.30
(2) Discount received .....	606.64
(3) Ending inventory .....	25,698.50
(4) Advertising expenses .....	442.45
(5) Traveling expenses .....	3,496.68
(6) Donations .....	1,194.00
(7) Dues and subscriptions .....	555.00
(8) Legal expense .....	9.00
<hr/>	
Total.....	\$156,818.58
Reductions:	
(9) Bad debts .....	2,328.27
<hr/>	
Net income adjusted .....	\$154,490.31

## EXPLANATION OF ADJUSTMENTS TO INCOME FROM BUSINESS

(1) Sales listed on your books in a total amount of \$676,-942.93 were understated by \$21,583.30. These sales were credited directly to your Personal Account on your books.

(2) You failed to include in income the amount of \$606.64, which you received from the Commonwealth Shoe and Leather Company, as discount on purchases.

(3) Book inventory of \$150,918.48 adjusted to corrected inventory of \$176,616.98.

(4) Advertising expense is reduced by allowance for advertising received from the Commonwealth Shoe and Leather Company in the amount of \$442.45.

(5) Traveling expense claimed of \$7,285.80 is reduced by \$3,496.68, which could not be substantiated.

(6) Donations are not allowable as a business expense. This deduction is allowed in computing net income in adjustment (i).

(7) Cost of membership in the Outrigger Canoe Club in the amount of \$555.00 is not a business expense.

(8) Legal expense in the amount of \$9.00, was a personal expense.

(9) To allow a deduction for bad debts in the amount shown.

(h) You failed to include in income the following amounts which are held to constitute taxable income to you:

Cash received from James B. Campbell.....	\$ 8,000.00
Sums deposited to various bank, brokerage and personal accounts .....	183,941.83

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(i) Contributions in the amount of \$1,194.00 are deductible in computing net income.

#### COMPUTATION OF INCOME TAX AND VICTORY TAX

Income tax net income adjusted .....	\$351,451.28
Less: Personal exemption .....	\$1,200.00
Credit for dependents .....	700.00      1,900.00
	<hr/>
Surtax net income .....	\$349,551.28
Less: Earned income credit—maximum.....	1,400.00
	<hr/>
Balance subject to normal tax.....	\$348,151.28
	<hr/>
Normal Tax at 6% on \$348,151.28.....	\$ 20,889.08
Surtax on \$349,551.28 .....	261,772.05
	<hr/>
Total income tax .....	\$282,661.13
Victory tax net income adjusted.....	\$348,824.37
Less: Specific exemption .....	624.00
	<hr/>
Income subject to victory tax.....	\$348,200.37

Victory tax before credit (5% of \$348,200.37) .....	\$ 17,410.02
Less: Victory tax credit—maximum.....	1,200.00
Net victory tax .....	\$ 16,210.02
Net income tax and victory tax (1).....	\$298,871.15
Income tax for 1942 (2).....	\$ 25,215.63
Amount of item (1) or (2) whichever is larger.....	\$298,871.15
Forgiveness feature:	
(a) Amount of item (1) or (2) which- ever is smaller .....	\$25,251.63
(b) Amount forgiven—75% of \$25,215.63 .....	18,911.72
(c) Amount unforgiven .....	\$ 6,303.91
Correct income tax and victory tax liability.....	\$305,175.06
Income tax and victory tax liability disclosed by return—No return filed	
Income tax and victory tax withheld by employer .....	None
Income tax paid on 1942 income.....	\$42,487.95
Tax paid on 1943 income on account of declaration of estimated tax.....	\$84,839.84
Total payments.....	\$127,327.79
Deficiency in income tax and victory tax.....	\$177,847.27
25% penalty on \$177,847.27 .....	\$ 44,461.82
50% penalty on \$305,175.06 .....	\$152,587.53

## TAXABLE YEAR ENDED DECEMBER 31, 1944

## ADJUSTMENTS TO NET INCOME

Net income as disclosed by return.....	\$ 58,840.86
Unallowable deductions and additional income: .....	\$ 131.92
(a) Interest income .....	\$ 131.92
(b) Dividends .....	\$ 1,906.40



(c) Rental income .....	\$ 360.00
(d) Income from business .....	\$117,007.69
(e) Capital gains .....	\$ 123.35
(f) Other income .....	\$ 60,723.58
	<hr/>
	\$180,252.94
	<hr/>
Net income adjusted .....	\$293,093.80

## EXPLANATION OF ADJUSTMENTS

(a) You failed to include in your gross income interest received in the amount of \$131.92.

(b) You omitted from your gross income dividends from stocks in the amount of \$1,906.40.

(c) You failed to report rental income received from the U. S. Army for a lease on property at Haleiwa, Oahu, in the amount of \$360.00.

(d) Income from your business, known as Manufacturer's Shoe Store, was found to be \$174,191.16 as compared to \$57,183.47 reported in your return. The difference of \$117,007.69 is composed of the following adjustments:

Item	Per Return	Corrected	Net Income Increase
(1) Gross Sales	\$346,296.91	\$351,206.95	\$ 4,910.04
(2) Bonus expense	3,660.27	3,635.83	24.44
(3) Net income from business (7/1/44-12/31/44)	None	112,073.21	\$112,073.21
			<hr/>
Increase in business income.....			\$117,007.69
Net income from business per return.....			57,183.47
			<hr/>
Net income from business corrected.....			\$174,191.16

EXPLANATION OF ADJUSTMENTS TO INCOME  
FROM BUSINESS

(1) You failed to report sales in the amount of \$4,910.04. These sales were credited directly to your Personal Account on your books.

(2) An accrued bonus was overstated in the amount of \$24.44.

(3) It has been determined that the Manufacturer's Shoe Store, an alleged partnership between Lawrence Santos and the Hawaiian Trust Company, Trustee for the Lawrence Santos Trust, is not a valid partnership for Federal income tax purposes, and that all income from the Manufacturer's Shoe Store is taxable to you, with the result that all income from the Manufacturer's Shoe Store reported on a fiduciary return filed for the trust is eliminated from such fiduciary return. In view of this determination, the income from the Manufacturer's Shoe Store, which you reported on a fiscal year basis in line with the fiscal year basis used by the alleged partnership, must be adjusted to the calendar year basis used on your individual income tax returns.

Accordingly, a portion of the income reported by the alleged partnership, Manufacturer's Shoe Store, for the period 7/1/44 to 2/28/45 is allocated to the calendar year 1944 based on the respective number of months in 1944. The computation of your business income from the alleged partnership, Manufacturer's Shoe Store is as follows:

Ordinary net income reported on partnership return for the period 7/1/44 to 2/28/45.....	\$148,436.35
Add: Capital expenditures erroneously charged to repairs .....	994.60

Ordinary net income for period 7/1/44 to 2/28/45 revised .....	\$149,430.95
Pro-rata portion of \$149,430.95 applicable to calendar year ended 12/31/45 (1/1/45 to 2/28/45): 2/8 of \$149,430.95 .....	37,357.74

Pro-rata portion of \$149,430.95 applicable to calendar year ended 12/31/44 (7/1/44 to 12/31/44): 6/8 of \$149,430.95 .....	\$112,073.21
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(e) You failed to report a portion of capital gains from the sale of stocks as follows:

300 shares, Mutual Telephone Co., Selling price, March, 1944 .....	\$4,186.42
Cost 6/11/43 .....	3,747.00
Gain .....	\$ 439.42
50% taxable .....	\$ 219.71

65 shares Mutual Telephone Co., Selling price,	
March, 1944 .....	\$894.08
Cost 6/23/43 .....	\$828.10
Gain .....	\$ 65.98
50% taxable .....	\$ 32.99
100 shares Hawaiian Electric Co., Selling	
price 3/8/44 .....	\$3,763.80
Cost 6/11/43 .....	\$3,486.00
Gain .....	\$ 277.80
50% taxable .....	\$ 138.90
Total capital gains adjusted .....	\$ 391.60
Capital gains per return.....	268.25
Understatement .....	\$ 123.35

(f) You failed to include in gross income sums deposited to various banks, brokerage and personal accounts in the amount of \$60,723.58, which are held to constitute taxable income to you.

#### COMPUTATION OF ALTERNATIVE TAX

Net income adjusted .....	\$239,093.80
Less: Excess of net long-term capital gain over net	
short term capital loss .....	391.60
Ordinary net income .....	\$238,702.20
Less: Surtax exemptions .....	2,000.00
Balance (surtax net income) .....	\$236,702.20
Surtax on \$236,702.20 .....	\$190,219.00
Ordinary net income .....	\$238,702.20
Less: Normal tax exemption .....	500.00
Balance subject to normal tax.....	\$238,202.20
Normal tax at 3% of \$238,202.20.....	\$ 7,146.07
Partial tax .....	\$197,365.07
Plus 50% of \$391.60 .....	195.80
Alternative tax .....	\$197,560.87

## COMPUTATION OF TAX

Net income adjusted .....	\$239,093.80	
Less: Surtax exemption .....	2,000.00	
		<hr/>
Surtax net income .....	\$237,093.80	
Surtax on \$237,093.80 .....	\$190,575.36	
Net income adjusted .....	\$239,093.80	
Less: Normal tax exemption .....	500.00	
		<hr/>
Balance subject to normal tax.....	\$238,593.80	
Normal tax at 3% of \$238,593.80.....		7,157.81
		<hr/>
Total normal tax and surtax.....	\$197,733.17	
		<hr/>
Correct income tax liability (alternative tax).....	\$197,560.87	
Income tax liability disclosed by return Account		
No. 300454 .....		33,625.76
		<hr/>
Deficiency in income tax.....	\$163,935.11	
50% penalty on \$163,935.11 .....	\$	81,967.56
		<hr/>

## TAXABLE YEAR ENDED DECEMBER 31, 1945

## ADJUSTMENTS TO NET INCOME

Net income disclosed by the original return.....	\$	91,398.88	
Unallowable deductions and additional income:			
(a) Dividends .....	\$	2,818.32	
(b) Interest income .....		12.75	
(c) Rental income .....		255.00	
(d) Income from business .....		65,962.30	
(e) Net capital gain .....		1,573.12	
(f) Other income .....		45,508.81	\$116,130.30
		<hr/>	<hr/>
Total.....			\$207,529.18
Non-taxable income and additional deductions:			
(g) Contributions .....	\$	545.60	
(h) Taxes .....		34.72	580.32
		<hr/>	<hr/>
Net income adjusted .....			\$206,948.86

## EXPLANATION OF ADJUSTMENTS

(a) You omitted from gross income dividends from stocks which your share under community property law of Hawaii was \$2,818.32.

(b) You omitted from gross income interest received, of which your community share was \$12.75.

(c) You failed to report rent received for property leased to the U. S. Army at Haleiwa, your community<sup>s</sup> share of which was \$255.00.

(d) It has been determined that the Manufacturer's Shoe Store, an alleged partnership between Lawrence Santos and Hawaiian Trust Company, a Trustee for the Lawrence Santos, Trust, is not a valid partnership for Federal income tax purposes, and that all income from the Manufacturer's Shoe Store is taxable to you, with the result that all income from the Manufacturer's Shoe Store reported on a fiduciary return filed for the trust is eliminated from such fiduciary return. In view of this determination the income from the Manufacturer's Shoe Store, which you reported on a fiscal year basis in line with the fiscal year used by the alleged partnership, must be adjusted to the calendar year basis used on your individual income tax returns.

Accordingly, a portion of the income reported by the alleged partnership Manufacturer's Shoe Store, for the fiscal year 3/1/44 to 2/28/45, and a portion of the income reported by the alleged partnership, Manufacturer's Shoe Store, for the fiscal year 3/1/45 to 2/28/46, is allocated to the calendar year 1945, based on the respective number of months in 1945.

The computation of your business income from the alleged partnership Manufacturer's Shoe Store is as follows:

Ordinary net income reported on partnership return		
for fiscal year 3/1/45 to 2/28/46 .....	\$221,096.12	
Add: Rental expenses disallowed as personal		
expenses .....	\$5,118.71	
Less: Rental income eliminated.....	\$1,600.00	3,518.71
	<hr/>	<hr/>
Ordinary net income for fiscal year 3/1/45 to		
2/28/46 .....	\$224,614.83	
Pro-rata portion of \$224,614.83 applicable to calendar		
year ended 12/31/46 to 2/28/46: 2/12 of \$224,614.83	37,435.80	



Pro-rata portion of \$224,614.83 applicable to calendar year ended 12/31/45 (3/1/45 to 12/31/45): 10/12 of \$224,614.83 .....\$187,179.03

Pro-rata portion of \$149,430.95, representing revised net income for fiscal period 7/1/44 to 2/28/45 applicable to calendar year ended 12/31/45 (1/1/45 to 2/28/45): 2/8 of \$149,430.95.....\$ 37,357.74

Revised business income from Manufacturer's Shoe Store .....\$224,536.77

Your share of revised business income under the community property law of Hawaii, which went into effect on June 1, 1945 is computed as follows:

Period	Your share	Your Wife's share
1/1/45 to 2/28/45 .....	\$ 37,357.74	
3/1/45 to 5/31/45 3/10 of \$187,179.03	56,153.71	
6/1/45 to 12/31/45 7/10 of \$187,179.03	65,512.66	\$ 65,512.66
	<hr/>	<hr/>
Totals.....	\$159,024.11	\$ 65,512.66
Reported on your return.....	93,061.81	
	<hr/>	
Business income increased.....	\$ 65,962.30	

(e) You reported a net capital gain of \$51.25 whereas it has been determined that the correct net capital gain was \$1,385.05 as follows:

## SHORT-TERM GAINS AND LOSSES

Name	Date Acquired	Date Sold	Sale Price	Cost	Gn/
60 shs. Mutual Telephone Co.	3/24/45	6/13/45	\$ 795.11	\$ 824.40	\$
500 shs. Bishop Nat'l Bank	3/27/45	7/16/45	19,069.00	19,500.00	(4
200 shs. Pac. Gas & Elec. Co.	7/3/45	8/30/45	7,901.34	8,140.65	(2
Total net short-term capital loss.....					\$ 6
Portion of loss attributable to your wife under the community property law of Hawaii 1/2 of \$239.31.....					\$ 1
Revised net short-term capital loss.....					\$ 5

## LONG-TERM GAINS AND LOSSES

Name	Date Acquired	Date Sold	Sale Price	Cost	Gn/
135 shs. Mutual Tel. Co.	6/23/43	2/21/45	\$1,838.17	\$1,719.90	\$ 1
100 shs. Mutual Tel. Co.	11/10/43	5/15/45	1,350.50	1,336.50	
47 shs. Mutual Tel. Co.	11/ 1/44	5/15/45	634.74	470.00	1
100 shs. Hawaiian Elect. Co.	6/23/43	6/20/45	4,161.80	3,685.00	4
100 shs. Hawaiian Elect. Co.	7/20/44	6/23/45	4,161.80	3,685.00	4
100 shs. Hawaiian Elect. Co.	10/26/44	7/ 2/45	4,161.80	3,785.00	3
100 shs. Consolidated Am. Co.	6/19/43	6/22/45	4,457.00	2,783.00	1,6
80 shs. Consolidated Am. Co.	7/ 6/44	6/22/45	3,565.60	2,708.00	8
200 shs. Alex. & Baldwin	7/ 3/44	6/16/45	8,923.60	8,674.00	2
Total gain .....					\$4,4
Net long-term capital gain—50% of \$4,408.61.....					\$2,2
Less: net short-term capital loss.....					\$ 5
Net capital gain adjusted.....					\$1,6
Net capital gain reported.....					\$
Capital gains increased.....					\$1,5

(f) You failed to include in your gross income sums deposited to various bank brokerage and personal accounts which are held to constitute taxable income to you, of which your community share was \$45,508.81.

(g) The deduction for contributions paid is increased as follows:

Contributions reported on partnership return for fiscal period 7/1/44-2/28/45 .....\$3,279.00

Pro-rata portion of \$3,279.00 applicable to calendar year ended 12/31/44 (7/1/44-12/31/44: 6/8 of \$3,279....\$2,459.25

Pro-rata portion of \$3,279 applicable to calendar year ended 12/31/45 (1/1/45-2/28/45: 2/8 of \$3,279.00..\$ 819.75

Contributions reported on partnership return for fiscal year ended 2/28/46 .....\$3,126.00

Pro-rata portion of \$3,126.00 applicable to calendar year ended 12/31/45 (3/1/45-12/31/45): 10/12 of \$3,126.00 .....\$2,605.00

Contributions from Manufacturer's Shoe Store.....\$3,424.75

Your share of contributions under the community property law of Hawaii which went into effect on June 1, 1945 is computed as follows:

Period	Your Share	Your Wife's Share
1/1/45-2/28/45 .....	\$ 819.75	
3/1/45-5/31/45 (3/10 of \$2,605.00 .....	\$ 781.50	
6/1/45-12/31/45 (7/10) of \$2,605.00 .....	\$ 911.75	\$ 911.75
Totals.....	\$2,513.00	\$ 911.75
Contributions deducted on your return .....	\$1,967.40	
Contributions increased .....	\$ 545.60	

(h) You are entitled to an additional deduction for taxes in the amount of \$34.72.

## COMPUTATION OF ALTERNATIVE TAX

Net income adjusted .....	\$206,948.86
Less: Excess of net long-term capital gain over net short term capital loss .....	\$ 1,624.37
Ordinary net income .....	\$205,324.49
Less: Surtax exemptions .....	1,500.00
Balance (Surtax net income) .....	\$205,824.49
Surtax on \$205,824.49.....	\$160,300.29
Ordinary net income (above).....	\$205,324.49
Less: Normal tax exemption .....	500.00
Balance subject to normal tax.....	\$204,824.49
Normal tax at 3% of \$204,824.49.....	\$ 6,144.73
Partial tax .....	\$166,445.02
Plus: 50% of \$1,624.37 .....	\$ 812.19
Alternative tax .....	\$167,257.21

## COMPUTATION OF INCOME TAX

Net income adjusted .....	\$206,948.86
Less: Surtax exemptions .....	\$ 1,500.00
Surtax net income .....	\$205,448.86
Surtax on \$205,448.86 .....	\$161,778.46
Net income adjusted .....	\$206,948.86
Less Normal tax exemption.....	500.00
Balance subject to normal tax.....	\$206,448.86
Normal tax at 3% of \$206,448.86.....	\$ 6,193.47
Total income tax .....	\$167,971.93
Correct income tax liability (alternative tax).....	\$167,257.21

Income tax liability disclosed on original return, Account No. 301954.....	\$61,243.06	
Additional assessment amended return Account No. Jan. 300501/48.....	425.17	61,668.23
Deficiency in income tax.....		\$105,588.98
50% penalty on \$106,014.15 (167,257.21 less \$61,243.06 .....		\$ 53,007.08

TAXABLE YEAR ENDED DECEMBER 31, 1946  
ADJUSTMENTS TO NET INCOME

Net income as disclosed by amended return.....	\$ 73,450.15
Unallowable deductions and additional income:	
(a) Income from business .....	\$33,199.73
(b) Net capital gain .....	4,462.94      37,662.67
Total.....	\$111,112.82
Nontaxable income and additional deductions:	
(c) Contributions .....	78.91
Net income adjusted .....	\$111,033.91

EXPLANATION OF ADJUSTMENTS

(a) It has been determined that the Manufacturer's Shoe Store an alleged partnership between Lawrence Santos and Hawaiian Trust Company, Trustee for Lawrence Santos Trust, is not a valid partnership for Federal income tax purposes, and that all income from the Manufacturer's Shoe Store is taxable, to you, with the result that all income from the Manufacturer's Shoe Store reported on a fiduciary return for the trust is eliminated from such fiduciary return. In view of this determination the income from the Manufacturer's Shoe Store, which you reported on a fiscal year basis in line with the fiscal year used by the alleged partnership, must be adjusted to the calendar year basis used on your individual income tax returns. Accordingly, a portion of the income reported by the alleged partnership, Manufacturer's Shoe Store, for the fiscal year 3/1/45 to 2/28/46 and a portion of the income reported by the alleged partnership, Manufacturer's Shoe Store, for the fiscal year 3/1/46 to 2/28/47 is allocated to the calendar year 1946, based on the respective number of months in 1946. The computation of your business income from the alleged partnership, Manufacturer's Shoe Store is as follows:



Ordinary net income reported on partnership return for the fiscal year 3/1/46 to 2/28/47.....	\$124,391.93
Add: Closing inventory understated.....	\$74,185.68
Rental expenses disallowed as	
personal expenses .....	4,968.00      79,153.68
Total.....	\$203,545.61
Less: Rental income eliminated.....	2,400.00
Ordinary net income for fiscal year 3/1/46 to 2/28/47 revised .....	\$201,145.61
Pro-rata portion of \$201,145.61 applicable to calendar year ended 12/31/47 (1/1/47 to 2/28/47): 2/12 of \$201,145.61 .....	\$ 33,524.27
Pro-rata portion of \$201,145.61 applicable to calendar year ended 12/31/46 (3/1/46 to 12/31/46): 10/12 of \$201,145.61 .....	\$167,621.34
Pro-rata portion of \$224,614.83, representing revised net income for fiscal year 3/1/45 to 2/28/46 applicable to calendar year ended 12/31/46 (1/1/46 to 2/28/46): 2/12 of \$224,614.83 .....	\$ 37,435.80
Revised business income from Manufacturer's Shoe Store .....	\$205,057.14
Your share of revised business income under the community property law of Hawaii (1/2 of \$205,057.14	\$102,528.57
Income from Manufacturer's Shoe Store reported on your return (1/2 of \$138,657.67) .....	\$ 69,328.84
Business income increased .....	\$ 33,199.73

(b) Represents a net long-term capital gain shown in the partnership return of income for the Manufacturer's Shoe Store for the fiscal year 3/1/46 to 2/28/47 which was incurred as of 9/17/46, and which is held to be includible in your 1946 income. Your total net capital gain for the year 1946 thus amounts to \$7,528.42, arrived at as follows:

Net capital gain per amended return.....	\$3,065.48
Additional net capital gain.....	\$4,462.94
Total.....	\$7,528.42

(c) You are entitled to an additional deduction for contributions reported on partnership returns for the Manufacturer's Shoe Store in the amount of \$78.91, computed as follows:

Contributions reported on partnership return for fiscal year 3/1/45-2/28/46 .....	\$ 3,126.00
Pro-rata portion of \$3,126.00 applicable to calendar year ended 12/31/46 (1/1/46 to 2/28/46): 2/12 of \$3,126.00 .....	521.00
Contributions reported on partnership return for fiscal year ended 2/28/47 .....	\$1,814.90
Pro-rata portion of \$1,814.90 applicable to calendar year ended 12/31/46 (3/1/46 to 12/31/46): 10/12 of \$1,814.90 .....	1,512.42
Total contributions from Manufacturer's Shoe Store....	\$ 2,033.42
One-half deductible by your wife, under the community property law of Hawaii .....	1,016.71
Your share of contributions from Manufacturer's Shoe Store .....	\$ 1,016.71
Contributions deducted on your return (1½ of \$1,875.60) .....	937.80
Contributions increased .....	\$ 78.91

#### COMPUTATION OF ALTERNATIVE TAX

Net income adjusted .....	\$111,033.91
Less: Excess of net long-term capital gain over net short-term capital loss .....	\$ 7,528.42
Ordinary net income .....	\$103,505.49
Less: Exemptions .....	1,500.00
Balance .....	\$102,005.49
Combined tentative normal tax and surtax on \$102,005.49 .....	\$ 69,104.89
Less: 5% of \$69,104.89 .....	3,455.24
Partial tax .....	\$ 65,649.65
Plus: 50% of \$7,528.42 .....	3,764.21
Alternative tax .....	\$ 69,413.86

## COMPUTATION OF TAX

Net income adjusted .....	\$111,033.91
Less: Exemptions .....	1,500.00
Balance .....	<u>\$109,533.91</u>
Combined tentative normal tax and surtax on \$109,533.91 .....	\$ 75,805.18
Less: 5% of \$75,805.18 .....	3,790.26
Combined normal tax and surtax.....	<u>\$ 72,014.92</u>
Correct income tax liability (alternative tax).....	\$ 69,413.86
Income tax liability disclosed by original return, Account No. July 320011/47....	\$39,845.28
Additional assessment amended return, Account No. Jan. 300800/48.....	875.00      40,720.28
Deficiency in income tax.....	<u>\$ 28,693.58</u>

[Endorsed]: T.C.U.S. Filed Feb. 5, 1953.

[Title of Tax Court and Cause.]

PETITIONER'S REPLY TO AFFIRMATIVE  
MATTER SET FORTH IN RESPOND-  
ENT'S ANSWER

Comes now Irmgard Santos, the petitioner above named, by her attorney R. A. Rogers, and by way of answer to the affirmative matter contained in respondent's answer, admits, denies and alleges as follows, to-wit:

I.

Denies for lack of information the allegations contained in Subdivision "A" of Paragraph X of respondent's answer.

## II.

Denies each and every, all and singular, the allegations contained in Subdivisions "B" and "C" of Paragraph X of respondent's answer.

Wherefore, Petitioner prays that respondent take nothing by his answer on file herein, and that the above entitled Court determine that there is no deficiency in taxes, penalties or interest due from petitioner and that petitioner is not a transferee either in law or in equity of Lawrence Santos in the amount of \$68,287.90, or in any other sum or at all and for such other and further relief as to the Court may seem meet and proper in the premises.

Dated: San Francisco, March 31, 1953.

/s/ R. A. ROGERS,

Counsel for Petitioner

Duly Verified.

[Endorsed]: T.C.U.S. Filed Apr. 6, 1953.

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[Title of Tax Court and Cause.]

## SECOND AMENDED PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau Symbols FC:IMJ—150D) dated October 15, 1952, and as a basis for her proceeding alleges as follows:

1. The petitioner is an individual with residence

at 3639 Diamond Head Road, Honolulu, Hawaii. The returns for the period here involved were filed by the petitioner's husband, Lawrence Santos, with the Collector of Internal Revenue for the District of Hawaii.

2. A notice of deficiency (a copy of which is attached to the Amended Petition filed herein on February 5, 1953, marked Exhibit A) was mailed to the petitioner at her husband's business address, 1051 Fort Street, Honolulu, on October 15, 1952. The petitioner's husband forwarded said notice to the petitioner (who was then living in California) on or about November 25, 1952 and it was received by the petitioner on November 26, 1952.

3. The deficiency as determined by the Commissioner is in income taxes (and penalties) of the petitioner's husband, Lawrence Santos, for the calendar years 1943, 1944, 1945 and 1946, a deficiency in the amount of \$68,287.90, plus interest, having been assessed against the petitioner as a transferee of assets of Lawrence Santos. The entire amount of the deficiency assessed is in controversy.

4. The determination of tax as set forth in said notice of deficiency is based upon the following errors:

(a) The Commissioner was in error in determining that the petitioner was liable as a transferee of assets of Lawrence Santos in the amount of \$68,287.90 because at the time the alleged transfers of assets took place Lawrence Santos was not insolvent.

(b) The Commissioner was in error in determin-



ing that the petitioner was liable as a transferee of assets of Lawrence Santos in the amount of \$68,-287.90 because there was no transfer of assets of Lawrence Santos to the petitioner. The alleged transfers to the petitioner of assets without consideration were in fact distributions to the petitioner of property which was already her own.

(c) The Commissioner is estopped from proceeding against the petitioner as transferee because of representations made by officials and representatives of the Bureau of Internal Revenue and because of the Commissioner's agreement to apply the proceeds of the assets alleged to have been transferred to the petitioner's individual income tax liability.

5. The facts upon which the petitioner relies as a basis for this proceeding are as follows:

(a) At the time of the alleged transfers of assets from Lawrence Santos to the petitioner in 1948, 1949 and 1950 the assets of Lawrence Santos exceeded his liabilities, other than additional federal income taxes not then known or assessed. The additional federal income taxes of Lawrence Santos for the years 1943, 1944, 1945 and 1946 were not known or assessed until December 26, 1951.

(b) In 1948, 1949 and 1950 Lawrence Santos purchaser cashiers' checks in the name of Lawrence Santos and/or Irmgard Santos in an aggregate principal amount of \$82,272.67 and delivered said checks to petitioner who retained them until 1950 when she delivered them to Lawrence

Santos to be used to purchase government bonds for her. Lawrence Santos used said checks to purchase \$80,000 principal amount of U. S. government bearer bonds which he immediately delivered to the petitioner who retained them until the time she used them to pay her taxes. Lawrence Santos delivered said cashiers' checks to the petitioner to satisfy her demands against him for her share in the shoe business to which they both contributed capital and services, for her share of community income during the period of community property in Hawaii (June 1, 1945 to June 30, 1949) and for her share in the proceeds of the sale of a home in 1950 owned by them as joint-tenants. The delivery to the petitioner of said cashiers' checks (and subsequently the government bonds purchased with said checks) constituted a distribution to her of her own property and not a transfer to her of assets of Lawrence Santos.

(c) The petitioner is informed and believes and upon such information and belief alleges that officials and representatives of the Bureau of Internal Revenue assured Lawrence Santos that if the \$70,000 in government bonds in the possession of the petitioner was used by her to pay her individual income tax liability for the years 1943-1947, all of her tax liabilities would be discharged in full and that if her taxes were in fact overpaid she would be entitled to a refund. Lawrence Santos persuaded petitioner to sell said bonds and apply the proceeds (\$68,287.90) to payment of individual income taxes asserted against her for 1943-1947 on the basis of said assurances. Said amount was paid to the Col-

lector of Internal Revenue in April, 1952 and a certificate of discharge of tax liens against the petitioner for the years 1943-1947 was issued on April 4, 1952. Notwithstanding the foregoing, on October 15, 1952 a notice of deficiency in the amount of \$68,287.90, based on petitioner's asserted liability as a transferee of assets of Lawrence Santos, was issued. The subsequent and final determination of the petitioner's individual income tax liabilities for 1943-1947 resulted in a determination of overpayments in excess of \$60,000.

Wherefore, the petitioner prays that this Court may hear the proceeding and determine that no deficiency is due from the petitioner as transferee of assets of Lawrence Santos.

/s/ M. M. GOODSILL,

Counsel for Petitioner

Duly Verified.

[Endorsed]: T.C.U.S. Filed July 23, 1954.

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[Title of Tax Court and Cause.]

## ANSWER TO SECOND AMENDED PETITION

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, Daniel A. Taylor, Chief Counsel, Internal Revenue Service, and for answer to the second amended petition filed by the above petitioner, admits, denies and alleges as follows:

1. Admits the allegations contained in paragraph 1 of the second amended petition.

2. Admits the allegations contained in the first sentence of paragraph 2 of the second amended petition, but denies the remaining allegations contained in paragraph 2 of the second amended petition for lack of sufficient information.

3. Admits the allegations contained in paragraph 3 of the second amended petition.

4. (a), (b) and (c). Denies the allegations of error contained in subparagraphs (a), (b) and (c) of paragraph 4 of the second amended petition.

5. (a). Denies the allegations contained in subparagraph (a) of paragraph 5 of the second amended petition.

(b). Admit that in 1948, 1949 and 1950 Lawrence Santos purchased cashier's checks in the name of Lawrence Santos and/or Irmgard Santos in aggregate principal amount of \$82,272.67; that the said Lawrence Santos in 1950 purchased U. S. Government Bearer Bonds in the principal amount of \$80,000 by use of the aforesaid cashier's checks; but denies the remaining allegations contained in subparagraph (b) of paragraph 5 of the second amended petition.

(c) Admits that said bonds were sold by Lawrence Santos in 1952 and the proceeds from the sale of said bonds, namely, \$68,287.90, was given to petitioner for the purpose of her satisfying her asserted individual Federal income tax liabilities as then had been asserted against her for the taxable years 1943 to 1947, inclusive; admits that on Octo-

ber 15, 1952 a notice of deficiency in the amount of \$68,287.90 was issued to petitioner as transferee of assets of Lawrence Santos; admits that the subsequent and final determination of petitioner's individual income tax liabilities for 1943 to 1947 resulted in a determination of overpayments in said years in excess of \$60,000; but denies the remaining allegations contained in subparagraph (c) of paragraph 5 of the second amended petition.

Wherefore, it is prayed that the petitioner's appeal be denied and the determinations of the Commissioner in all respects be approved.

/s/ DANIEL A. TAYLOR,  
Chief Counsel, Internal Revenue  
Service

Of Counsel:

Melvin L. Sears,  
Regional Counsel  
R. E. Maiden, Jr.,  
Special Assistant to the Regional Counsel,  
Internal Revenue Service

[Endorsed]: T.C.U.S. Filed July 23, 1954.

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[Title of Tax Court and Cause.]

## AMENDMENT TO ANSWER TO SECOND AMENDED PETITION

Comes now the respondent, by his attorney, Daniel A. Taylor, Chief Counsel, Internal Revenue



Service, and amends the answer to second amended petition filed with the Court on July 23, 1954, as follows, to wit:

Immediately after subparagraph (c) of paragraph 5 on page 2 and immediately before the wherefore clause on page 3, the following additional allegations are made:

6. Further answering, and for affirmative allegations in connection with the liability of the petitioner as transferee of the assets of Lawrence Santos, respondent alleges as follows:

(a) There have been assessed against Lawrence Santos deficiencies in Federal income taxes and penalties for the years 1943 to 1946, inclusive, aggregating \$808,088.93, as is more fully set out in the notice of deficiency, a copy of which is attached to the amended petition, which taxes and penalties together with interest thereon as provided by law have not been paid and are still due and unpaid.

(b) Subsequent to the due date of said taxes, Lawrence Santos transferred, conveyed, and delivered to the petitioner United States government bonds having a cash value of not less than \$68,287.90, which transfer left Lawrence Santos insolvent and without money or assets to pay the aforesaid deficiencies.

(c) The petitioner received said United States government bonds without consideration, and by reason of the receipt of said bonds this petitioner became a transferee of said Lawrence Santos within the meaning of the applicable statutes, and as such,

is liable for the payment of said deficiencies to the extent of the value of the assets so received by her.

/s/ DANIEL A. TAYLOR,

Chief Counsel, Internal Revenue  
Service

Of Counsel:

Melvin L. Sears,

Regional Counsel

E. C. Crouter,

Assistant Regional Counsel

R. E. Maiden, Jr.,

Special Assistant to the Regional Counsel,  
Internal Revenue Service

[Endorsed]: T.C.U.S. Filed Oct. 15, 1954.

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[Title of Board and Cause.]

### STIPULATION OF FACTS

It is hereby stipulated and agreed between the Commissioner of Internal Revenue and the above-entitled petitioner, by their respective counsel of record, that the following facts shall be taken as true, provided however, that this stipulation does not waive the right of either party to introduce other evidence not at variance with the facts herein stipulated, or to object to the introduction in evidence of any such facts on the grounds of immateriality or irrelevancy.

1. Petitioner is an individual whose mailing address is now 3639 Diamond Head Road, Honolulu,

Territory of Hawaii. Petitioner is married to Lawrence Santos of Honolulu. They were married in 1928.

2. On October 15, 1952 the Commissioner of Internal Revenue mailed petitioner as transferee of assets of Lawrence Santos a notice of deficiency in the amount of \$68,287.90, said notice of deficiency being in the form attached as an exhibit to the Amended Petition filed in this case on February 5, 1953.

3. In 1937 Persans, Limited, a Hawaii corporation, was organized to engage in the retail shoe business in Honolulu. Persans, Limited was capitalized at \$20,000 and stock of the par value of \$5,000 was issued to and in the name of Lawrence Santos and dividends paid thereon were paid to him individually; the balance of the outstanding and issued shares of stock of the par value of \$15,000 was issued to other stockholders. The \$5,000 contributed in payment for the \$5,000 par value of stock issued to Lawrence Santos, as aforesaid, was obtained by loan from the uncle of Lawrence Santos, obtained on a promissory note signed by Lawrence Santos and petitioner and secured by a mortgage on home located on Oahu Avenue, Manoa Valley, Honolulu, owned by Lawrence Santos and petitioner as joint tenants. The mortgage was signed by both Lawrence Santos and petitioner.

4. Lawrence Santos received a salary from Persans, Limited and worked full time for the company. Petitioner worked for the company on Saturdays. Lawrence Santos gradually acquired

through purchase or inheritance all of the stock of Persans, Limited.

5. In May, 1942, Lawrence Santos purchased Manufacturers' Shoe Store in Honolulu for \$50,000. Lawrence Santos personally had no funds to make this purchase and it was financed as follows: Persans, Limited borrowed \$50,000 from the Bishop National Bank, pledging its assets as security. Persans, Limited then loaned \$50,000 to Lawrence Santos who paid it to seller of Manufacturers' Shoe Store. In December, 1942 Lawrence Santos liquidated Persans, Limited and the proceeds of the liquidation (\$43,750.35) were paid to Lawrence Santos, doing business as Manufacturers' Shoe Store as an individual proprietorship until July 1, 1944.

6. On July 1, 1944 Lawrence Santos created an irrevocable trust by transfer to Hawaiian Trust Company, Limited of the sum of \$70,000, the beneficiaries of the trust being the two children of Lawrence Santos and petitioner. A limited partnership was organized in accordance with the laws of the Territory of Hawaii by and between Lawrence Santos, as general partner, and Hawaiian Trust Company, Limited, Trustee, under Deed of Trust dated July 1, 1944, as limited partner, for the purpose of acquiring at the close of business on June 30, 1944, all the assets of, and to carry on the business heretofore carried on and conducted by Lawrence Santos under the name of Manufacturers' Shoe Store, in accordance with a limited partnership agreement between Lawrence Santos and Hawaiian Trust Company, Limited, dated as of July 1, 1944.



Lawrence Santos transferred to said limited partnership all of his right, title and interest in the assets of the business formerly carried on by him under the name of Manufacturers' Shoe Store, having a net book value of \$105,000, in exchange for a 60 per cent interest in said limited partnership, and Hawaiian Trust Company, Limited, as Trustee, at the same time contributed the sum of \$70,000 and acquired ownership of a 40 per cent interest in said partnership. At the time of the creation of the limited partnership no share therein was given to petitioner in recognition of any interest she might have or claim in the business formerly carried on as Manufacturers' Shoe Store or in the business of Persans, Limited.

7. Effective June 1, 1945 the Territory of Hawaii adopted a Community Property Law providing in part that all property, including earnings of the husband and earnings of the wife and including rents, issues, income and other profits of the separate property of the husband and rents, issues, income and other profits of the separate property of the wife, acquired by the husband or by the wife after marriage or after effective date of the law, whichever is the later, shall be the community property of the husband and wife. Chapter 301A, Series D-201, Session Laws of Hawaii 1945. This Community Property Law was repealed effective June 30, 1949. Series D-296, Session Laws of Hawaii 1949.

8. On March 1, 1947 Manufacturers' Shoe Company, Limited was incorporated to take over the



assets and liabilities of the limited partnership. The corporation was capitalized at \$350,000, Lawrence Santos receiving capital stock of the par value of \$210,000 and Hawaiian Trust Company, Limited, as Trustee, receiving capital stock of the par value of \$140,000.

9. In the early part of 1948 Lawrence Santos requested Cameron and Johnstone, auditors for the corporation and for the limited partnership, to determine what portion of the capital stock of \$210,000 issued to him at incorporation of Manufacturers' Shoe Company, Limited, represented earnings since June 1, 1945, i.e. that portion which represented community property. Cameron and Johnstone made an examination, and on April 5, 1948 advised Lawrence Santos that \$105,000 out of the \$210,000 was community property and that his wife would be entitled to receive stock of the par value of \$52,500 in recognition of her community property interest in the earnings of the business from June 1, 1945, to February 28, 1947. On or about April 5, 1948, Lawrence Santos then transferred to petitioner, as of March 1, 1947, capital stock of Manufacturers' Shoe Company of the par value of \$52,500 out of his share of the capital stock of the Company, leaving him stock of the par value of \$157,500.

10. From August, 1951 to June, 1952 petitioner lived on the West Coast. She returned to Honolulu in June, 1952 and stayed until August, 1952 when she finally moved to California. In October, 1952 petitioner filed an action in a California court for separate maintenance. Personal service, however,

was never obtained on Lawrence Santos in said action. In December, 1953 petitioner returned to Honolulu where she is now living.

11. Petitioner's share of the community income of herself and Lawrence Santos for the period from June 1, 1945 (commencement of community property) to February 28, 1947 (the date of the organization of the corporation) was as follows:

June 1, 1945 - December 31, 1945.....	\$ 15,621.92
January 1, 1946 - December 31, 1946.....	54,400.31
January 1, 1947 - February 28, 1947.....	41,564.78
<hr/>	
Total.....	\$111,587.01

Petitioner's share of the community income of herself and husband for the period from March 1, 1947 to July 1, 1949 (the end of community property) was as follows:

March 1, 1947 - December 31, 1947.....	\$ 11,610.60
January 1, 1948 - December 31, 1948.....	21,063.38
January 1, 1949 - June 30, 1949 .....	10,715.52
<hr/>	
Total.....	\$ 43,389.50

12. Petitioner's Federal income tax liability on her community income as aforesaid for the taxable years 1945, 1946, 1947, 1948, and 1949 was \$5,240.96, \$28,257.97, \$27,384.49, \$6,165.16 and \$3,241.33, respectively.

13. After U. S. Federal taxes petitioner's aggregate community income for the aforesaid taxable years (during the community property period) was \$84,686.60.

14. On April 15, 1948 Lawrence Santos purchased from Bishop National Bank a cashier's check

in the amount of \$14,000 made payable to Lawrence Santos and/or Irmgard Santos. On April 16, 1948 Lawrence Santos purchased a cashier's check from the Bishop National Bank in the amount of \$12,-328.80 made payable to Lawrence Santos and/or Irmgard Santos. On November 16, 1948 Lawrence Santos purchased a cashier's check from Bishop National Bank in the amount of \$15,000 made payable to Lawrence Santos and/or Irmgard Santos. On May 13, 1949 Lawrence Santos purchased from Bishop National Bank a cashier's check in the amount of \$10,718.77 made payable to Lawrence Santos and/or Irmgard Santos. On May 16, 1949, Lawrence Santos purchased from Bishop National Bank a cashier's check in the amount of \$13,547.14 made payable to Lawrence Santos and/or Irmgard Santos. On August 8, 1950 Lawrence Santos purchased from Bishop National Bank a cashier's check in the amount of \$10,448.84 made payable to Lawrence Santos and/or Irmgard Santos. On September 18, 1950 Lawrence Santos purchased from Bishop National Bank a cashier's check in the amount of \$6,229.12 made payable to Lawrence Santos and/or Irmgard Santos. Lawrence Santos went to California in November of 1950. On November 22, 1950 Lawrence Santos took the aforesaid cashier's checks to Schwabacher & Co., San Francisco, and thereupon purchased \$80,000 principal amount of U. S. Treasury 2½% Bearer Bonds for a total price of \$81,674.32. Lawrence Santos alone endorsed the cashier's checks. Lawrence Santos took delivery of the bonds on Novem-

ber 27, 1950 from Schwabacher & Co. and gave his receipt therefor.

15. The aforesaid corporation, Manufacturers' Shoe Company, Limited, from the time of its incorporation on March 1, 1947 through the taxable year 1952, declared and paid dividends in the fiscal years ended February 28, 1949 and February 28, 1951 in the respective amounts of \$8,750 each year. Petitioner's pro rata share of the 1949 dividend from her aforesaid stockholdings in said corporation is included in the amount of her community income set forth in paragraph 11 hereinabove.

16. The total value of the assets of Lawrence Santos as of December 31 of each of the following years was in the amount for each of said years as follows:

December 31, 1947.....	\$214,640.60
December 31, 1948.....	205,813.93
December 31, 1949.....	215,372.66
December 31, 1950.....	236,843.73
December 31, 1951.....	237,302.02
December 31, 1952.....	213,452.24

On December 26, 1951 the first assessment was made against Lawrence Santos with respect to Federal income tax deficiencies for the years 1943, 1944, 1945 and 1946. An additional assessment was made on February 27, 1952. The unpaid liability of Lawrence Santos for Federal income taxes and penalties, incurred but not assessed, at December 31, 1948, December 31, 1949 and December 31, 1950 was \$415,427.73, plus interest. The tax liability at December 31, 1951 and December 31, 1952 was the

same, namely, \$415,427.73, plus interest. In addition to the aforesaid Federal tax liabilities Lawrence Santos as of December 31 of each of the years 1948, 1949, 1950, 1951 and 1952 was indebted to the Manufacturers' Shoe Store in the amounts of \$91,-651.69, \$105,856.50, \$120,404.73, \$127,308.70 and \$127,511.70, respectively.

17. On March 27, 1952 petitioner took the aforesaid bonds, in the face amount of \$70,000 to Berl & Company, San Francisco and sold them for the total amount of \$68,287.90 for which checks in said amount of \$68,287.90 were made payable to petitioner. Petitioner endorsed these checks in favor of Smith, Wild, Beebe and Cades of Honolulu. The checks were deposited by Smith, Wild, Beebe and Cades in their trust account and that firm then made a check payable to the Collector of Internal Revenue in the same amount (\$68,287.90) in payment of the individual taxes asserted against petitioner for the taxable years 1943 to 1947, inclusive, in the jeopardy assessments which had been levied against her. On April 4, 1952 a Certificate of Discharge of Tax Liens against petitioner for the aforesaid years 1943 to 1947, inclusive, was issued by the Collector of Internal Revenue and duly recorded.

18. In the subsequent and final determination of petitioner's individual income tax liabilities for the taxable years 1943 to 1947, inclusive, which were at issue before The Tax Court of the United States in Docket No. 42682, it was determined that petitioner had overpaid her income tax liabilities for



the taxable years 1945 and 1946 in the amounts of \$24,768.51 and \$38,237.18, respectively.

19. A copy of the stipulation of settlement showing said overpayments due to petitioner which was filed with The Tax Court of the United States in Docket No. 42682 at the time of the call of the Court's calendar in Honolulu on July 15, 1954 is attached hereto as Exhibit 1-A to this stipulation of facts.

20. On April 4, 1950, the house at Halelea Place, Manoa Valley, Honolulu, owned by petitioner and Lawrence Santos as joint tenants, was sold for \$21,000. After deduction of \$1,085.10 expenses, net proceeds were \$19,914.90. The Halelea Place house was purchased by the petitioner and her husband on September 23, 1941 for \$14,250, utilizing proceeds from the sale of the house on Oahu Avenue which had been owned by them as joint tenants and which had been sold on March 12, 1941. The Oahu Avenue house was purchased on July 26, 1937, utilizing proceeds from the sale of a house on Liliha Street, Honolulu, owned by the petitioner and her husband as joint tenants.

/s/ M. M. GOODSILL

Counsel for Petitioner

/s/ DANIEL A. TAYLOR

Chief Counsel, Internal Revenue  
Service, Counsel for Respondent

[Endorsed]: T. C. U. S. Filed July 23, 1954.

## EXHIBIT No. 1-A

The Tax Court of the United States

Docket No. 42682

Irmgard Santos, Petitioner, vs. Commissioner of  
Internal Revenue, Respondent.

## STIPULATION

It is hereby stipulated that there are deficiencies in Federal income tax and penalty due from petitioner for the taxable year 1943 in the amounts of \$134.63 and \$33.66, respectively, without considering the jeopardy assessment made before the issuance of the deficiency notice.

It is hereby stipulated that the following statements show the petitioner's income tax liabilities for the taxable years 1945 and 1946:

## 1945

Assessed and paid .....\$30,009.47

## Payments:

December 30, 1947.....\$ 109.83

January 8, 1952 ..... 140.63

April 3, 1952 ..... 10,264.09

April 3, 1952 ..... 19,130.81

Payment transferred from year 1943..... 235.91

Estimated tax payment ..... 128.20

(Share of Lawrence Santos allocated to  
petitioner) \_\_\_\_\_

Total paid .....\$ 30,009.47

Liability ..... 5,240.96

Overpayment (Sec. 322(d), I.R.C.) .....\$24,768.51

Original return filed March 15, 1946.

Original Consent Form 872 executed on February 10, 1949.

Renewal Consents extending the Statute to June 30, 1952 executed on the following dates: June 20, 1950, March 6, 1951.

Deficiency notice dated February 20, 1952.

Claim for refund filed April 2, 1954.

## 1946

Assessed and paid: .....\$66,495.15

## Payments:

September 26, 1947 .....\$ 2,500.00

October 31, 1947 ..... 2,500.00

November 28, 1947 ..... 2,500.00

December 23, 1947 ..... 2,500.00

January 27, 1948 ..... 2,500.00

February 27, 1948 ..... 2,500.00

April 2, 1948 ..... 2,713.49

April 3, 1952 ..... 26,566.61

Petitioner's one-half of joint payments

on estimated tax ..... 22,215.05

Total paid .....\$66,495.15

Liability ..... 28,257.97

Overpayment (Sec. 322(d), I.R.C.) .....\$38,237.18

Original return filed June 16, 1947.

Original Consent Form 872 executed on January 4, 1950.

Renewal Consent extending the Statute to June 30, 1952, executed on December 29, 1950.

Deficiency notice dated February 20, 1952.

Claim for refund filed April 2, 1954.

/s/ Milton Cades,

Counsel for Petitioner

/s/ Daniel A. Taylor—R.P.H.

Chief Counsel, Internal Revenue  
Service

Counsel for Respondent

REM/jus 6/25/54

[Endorsed]: T.C.U.S. Filed July 15, 1954.

[Title of Tax Court and Cause.]

SUPPLEMENTAL STIPULATION OF FACTS

It is hereby stipulated and agreed between the Commissioner of Internal Revenue and the above-entitled petitioner, by their respective counsel of record, that the following fact shall be taken as true.

The unpaid liability of Lawrence Santos for Federal income taxes and penalties, incurred but not assessed, at December 31, 1947 was \$415,427.73, plus interest.

/s/ M. M. GOODSILL  
Counsel for Petitioner

/s/ DANIEL A. TAYLOR  
Chief Counsel, Internal Revenue  
Service, Counsel for Respondent

[Endorsed]: T. C. U. S. Filed Nov. 2, 1954.

26 T. C. No. 71

Tax Court of the United States

Docket No. 46327

IRMGARD SANTOS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Filed June 18, 1956.

## FINDINGS OF FACT AND OPINION

Respondent determined liability against petitioner, as transferee, for the income tax liability of her husband, Lawrence Santos, for the years 1943 to 1946, inclusive. Held:

1. Petitioner is liable as transferee to the extent of \$68,287.90 representing the value of part of the assets received by her from Lawrence Santos, transferor.

2. Petitioner has failed to show any basis for the application of the doctrine of estoppel.

M. M. Goodsill, Esq., for the petitioner.

R. E. Maiden, Jr., Esq., and E. A. Tonjes, Esq., for the respondent.

This proceeding involves the transferee liability of petitioner for the income tax liability of Lawrence Santos, transferor, for the taxable years 1943 to 1946, inclusive, to the extent of \$68,287.90, representing the value of part of the assets received by her from the transferor.



The issues are (1) whether petitioner is liable to the extent of \$68,287.90 for income taxes for the years 1943 to 1946, inclusive, as transferee of assets of Lawrence Santos, her husband, and (2) whether the respondent is estopped from proceeding against the petitioner as transferee.

### Findings of Fact

The stipulated facts are found accordingly.

Petitioner is a resident of the City of Honolulu, Territory of Hawaii. In 1928 petitioner was married to Lawrence Santos, of Honolulu.

On October 15, 1952, the Commissioner of Internal Revenue mailed petitioner, as transferee of assets of Lawrence Santos, a notice of deficiency in the amount of \$68,287.90.

At the time the petitioner was married to Lawrence Santos they were both employed. Petitioner was receiving a salary of \$125 a month, which was increased later to \$165 a month. Lawrence Santos was receiving a salary of \$175 a month, which was increased to \$200 a month. At the time Lawrence started Persans, Limited, he had no assets other than the salaries of himself and wife.

Lawrence worked full time for Persan's Limited, and received a salary. Petitioner worked at Persans, Limited, on Saturdays and other days after she had completed her regular job. She was not paid a salary for working at Persan's, Limited, and was never paid anything by her husband for whatever contributions to the capital of the business, if any,

which she may have made from her compensation received from her regular employment. Lawrence gradually acquired, through purchase or inheritance, all of the stock of Persans, Limited.

In 1937 Persans, Limited, a Hawaii corporation, was organized to engage in the retail shoe business in Honolulu. Persans, Limited, was capitalized at \$20,000 and stock of the par value of \$5,000 was issued to and in the name of Lawrence Santos, and dividends paid thereon were paid to him individually; the balance of the outstanding and issued shares of stock of the par value of \$15,000 was issued to other stockholders. The \$5,000 contributed in payment for the \$5,000 par value of stock issued to Lawrence Santos was obtained by loan from the uncle of Lawrence Santos on a promissory note signed by Lawrence Santos and petitioner, and secured by a mortgage on a house located on Oahu Avenue, Manoa Valley, Honolulu, owned by Lawrence Santos and petitioner as join tenants. The mortgage was signed by both Lawrence Santos and petitioner.

The \$5,000 which Lawrence borrowed from his uncle for an investment in Persans, Limited, was repaid out of his joint checking account.

In May, 1942 Lawrence Santos purchased Manufacturers' Shoe Store in Honolulu for \$50,000. He personally had no funds to make this purchase and it was financed as follows: Persans, Limited, borrow \$50,000 from the Bishop National Bank, pledging its assets as security. Persans, Limited, then

loaned \$50,000 to Lawrence Santos who paid it to the seller of Manufacturers' Shoe Store. In December, 1942 Lawrence Santos liquidated Persans, Limited, and the proceeds of the liquidation (\$43,750.35) were paid to Lawrence Santos, doing business as Manufacturers' Shoe Store as an individual proprietorship until July 1, 1944.

On July 1, 1944, Lawrence Santos created an irrevocable trust by transfer to Hawaiian Trust Company, Limited, of the sum of \$70,000, the beneficiaries of the trust being the two children of Lawrence Santos and petitioner. A limited partnership was organized in accordance with the laws of the Territory of Hawaii by and between Lawrence Santos, as general partner, and Hawaiian Trust Company, Limited, Trustee, under Deed of Trust dated July 1, 1944, as limited partner, for the purpose of acquiring at the close of business on June 30, 1944, all the assets of, and to carry on the business heretofore carried on and conducted by, Lawrence Santos under the name of Manufacturers' Shoe Store, in accordance with a limited partnership agreement between Lawrence Santos and Hawaiian Trust Company, Limited, dated as of July 1, 1944. Lawrence Santos transferred to such limited partnership all of his right, title, and interest in the assets of the business formerly carried on by him under the name of Manufacturers' Shoe Store, having a net book value of \$105,000, in exchange for a 60 per cent interest in such limited partnership, and Hawaiian Trust Company, Limited, as Trustee, at the same time contributed the sum of

\$70,000 and acquired ownership of a 40 per cent interest in such partnership. At the time of the creation of the limited partnership no share therein was given to petitioner in recognition of any interest she might have or claim in the business formerly carried on as Manufacturers' Shoe Store or in the business of Persans, Limited.

Effective June 1, 1945, the Territory of Hawaii adopted a community property law providing in part that all property, including earnings of the husband and earnings of the wife, and rents, issues, income, and other profits of the separate property of the husband, and rents, issues, income, and other profits of the separate property of the wife, acquired by the husband or by the wife after marriage or after effective date of the law, whichever is the later, shall be the community property of the husband and wife. Ch. 301A, sr. D-201, Session Laws of Hawaii 1945. This community property law was repealed effective June 30, 1949. Ch. 301A, sr. D-296, Session Laws of Hawaii 1949.

On March 1, 1947, Manufacturers' Shoe Company, Limited, was incorporated to take over the assets and liabilities of the limited partnership. The corporation was capitalized at \$350,000, Lawrence Santos receiving capital stock of the par value of \$210,000, and Hawaiian Trust Company, Limited, as Trustee, receiving capital stock of the par value of \$140,000.

In the early part of 1948 Lawrence Santos requested Cameron and Johnstone, auditors for the corporation and for the limited partnership, to de-



termine what portion of the capital stock of \$210,000 issued to him at incorporation of Manufacturers' Shoe Company, Limited, represented earnings since June 1, 1945, i.e., that portion which represented community property. Cameron and Johnstone made an examination, and on April 5, 1948, advised Lawrence Santos that \$105,000 out of the \$210,000 was community property and that his wife would be entitled to receive stock of the par value of \$52,500 in recognition of her community property interest in the earnings of the business from June 1, 1945, to February 28, 1947. On or about April 5, 1948, Lawrence Santos then transferred to petitioner, as of March 1, 1947, capital stock of Manufacturers' Shoe Company of the par value of \$52,500 out of his share of the capital stock of the company, leaving him stock of the par value of \$157,500.

From August, 1951 to June, 1952 petitioner lived on the West Coast. She returned to Honolulu in June, 1952 and stayed until August, 1952 when she finally moved to California. In October, 1952 petitioner filed an action in a California court for separate maintenance. Personal service, however, was never obtained on Lawrence Santos in such action. In December, 1953 petitioner returned to Honolulu, where she is now living.

Petitioner's share of the community income of herself and Lawrence Santos for the period from June 1, 1945 (commencement of community property), to February 28, 1947 (the date of the organization of the corporation), was as follows:



June 1, 1945 - December 31, 1945.....	\$ 15,621.92
January 1, 1946 - December 31, 1946 .....	54,400.31
January 1, 1947 - February 28, 1947.....	41,564.78

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Total .....\$111,587.01

Petitioner's share of the community income of herself and husband for the period from March 1, 1947, to July 1, 1949 (the end of community property), was as follows:

March 1, 1947 - December 31, 1947.....	\$ 11,610.60
January 1, 1948 - December 31, 1948 .....	21,063.38
January 1, 1949 - June 30, 1949 .....	10,715.52

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Total.....\$ 43,389.50

Petitioner's Federal income tax liability on her community income as aforesaid for the taxable years 1945, 1946, 1947, 1948, and 1949 was \$5,240.96, \$28,257.97, \$27,384.49, \$6,165.16 and \$3,241.33, respectively.

Petitioner's aggregate community income during the community property period, after Federal income tax liability, was \$84,686.60.

Lawrence Santos purchased from Bishop National Bank cashier's checks payable to Lawrence Santos and/or Irmgard Santos, on the dates and in the amounts as follows:

Date	Amount
April 15, 1948 .....	\$ 14,000.00
April 16, 1948 .....	12,328.80
November 16, 1948 .....	15,000.00
May 13, 1949 .....	10,718.77
May 16, 1949 .....	13,547.14
August 8, 1950 .....	10,448.84
September 18, 1950 .....	6,229.12

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Total.....\$82,272.67

Lawrence gave the cashier's checks to petitioner who retained them. In November, 1950 Lawrence went to California, and on November 22, 1950, he received the checks from petitioner; Lawrence alone endorsed them and purchased through Schwabacher & Company, San Francisco, \$80,000 principal amount of U. S. Treasury 2½% per cent Bearer Bonds for the total price of \$81,674.32. On November 27, 1950, Lawrence took delivery of the bonds and gave his receipt therefor. Lawrence delivered the U. S. Treasury bonds to petitioner who retained them until sold. One \$10,000 bond was sold on April 1, 1952, and the proceeds were used to pay the joint Territorial taxes of petitioner and her husband.

On March 27, 1952, petitioner sold the bonds in the principal amount of \$70,000 through Berl & Company, San Francisco, for the total amount of \$68,287.90, and received checks in that amount payable to her order. Petitioner endorsed the checks in favor of Smith, Wild, Beebe and Cades, of Honolulu. The latter firm deposited the checks in a trust account and then made a check payable to the collector of internal revenue in the amount of \$68,287.90 in payment of the individual taxes asserted against petitioner for the taxable years 1943 to 1947, inclusive, in the jeopardy assessments which had been levied against her. On April 4, 1952, a certificate of discharge of tax liens against petitioner for the years 1943 to 1947, inclusive, was issued by the collector of internal revenue and duly recorded.

In the subsequent and final determination of peti-

tioner's individual income tax liabilities for the years 1943 to 1947, inclusive, which were at issue before The Tax Court of the United States in docket No. 42682, it was determined that petitioner had overpaid her income tax liabilities for the years 1945 and 1946 in the amounts of \$24,768.51 and \$38,237.18, respectively.

The Manufacturers' Shoe Company, Limited, from the time of its incorporation on March 1, 1947, through the taxable year 1952, declared and paid dividends in each of the fiscal years ended February 28, 1949, and February 28, 1951, in the amount of \$8,750. Petitioner's pro rata share of the 1949 dividend from her aforesaid stockholdings in the corporation is included in the amount of her community income hereinabove set forth.

The total value of the assets of Lawrence Santos as of December 31 of each of the following years was in the amount for each of such years as follows:

Year	Amount
December 31, 1947 .....	\$214,640.60
December 31, 1948 .....	205,813.93
December 31, 1949 .....	215,372.66
December 31, 1950 .....	236,843.73
December 31, 1951 .....	237,302.02
December 31, 1952 .....	213,452.24

On December 26, 1951, the first assessment was made against Lawrence Santos with respect to Federal income tax deficiencies for the years 1943, 1944, 1945, and 1946. An additional assessment was made on February 27, 1952. The unpaid liability of Lawrence Santos for Federal income taxes and penalties, incurred but not assessed, at December 31,

1948, December 31, 1949, and December 31, 1950, was \$415,427.73, plus interest. The tax liability at December 31, 1951, and December 31, 1952, was the same, namely, \$415,427.73, plus interest. In addition to the aforesaid Federal tax liabilities Lawrence Santos, as of December 31 of each of the years 1948, 1949, 1950, 1951, and 1952, was indebted to the Manufacturers' Shoe Store in the amounts of \$91,651.69, \$105,856.50, \$120,404.73, \$127,308.70, and \$127,511.70, respectively.

For 1952 petitioner and her husband filed separate income tax returns. Lawrence Santos claimed a loss on his return in the amount of \$4,244.94 incurred on the sale in that year of the \$80,000 U. S. Treasury bonds here in question. Petitioner reported no such transaction or loss on her individual returns although her attorney, who prepared her return, had knowledge that the bonds had been sold. On April 5, 1954, petitioner filed a joint return for the year 1952.

On April 4, 1950, the house at Halelea Place, Manoa Valley, Honolulu, owned by petitioner and Lawrence Santos as joint tenants, was sold for \$21,000. After deduction of \$1,085.10 expenses, net proceeds were \$19,914.90. The Halelea Place house was purchased by the petitioner and her husband on September 23, 1941, for \$14,250, utilizing proceeds from the sale of the house on Oahu Avenue which had been owned by them as joint tenants and which had been sold on March 12, 1941. The Oahu Avenue house was purchased on July 26, 1937, utilizing proceeds from the sale of a house on



Liliha Street, Honolulu, owned by the petitioner and her husband as joint tenants.

The Santos family consisted of petitioner, her husband, and their two minor children. They maintained a home with over \$50,000 worth of furniture in it, and they operated three late-model automobiles. The family was maintained in a manner and style commensurate with the community income.

During the period December 31, 1947, to December 31, 1952, Lawrence Santos was insolvent.

During the period April 15, 1948, to March 27, 1952, Lawrence Santos gratuitously transferred to petitioner property having a value of at least \$68,287.90, and petitioner is liable as transferee to that extent.

Petitioner has failed to show facts sufficient to constitute an estoppel.

### Opinion

LeMire, Judge: The primary question presented is whether petitioner is liable as a transferee within the meaning of section 311 of the Internal Revenue Code of 1939.

The respondent has the burden of establishing the receipt of property by the transferee, lack of consideration for the transfer, and the insolvency of the transferor at the time of or immediately after the transfer. There is no issue as to the transferor's liability for income tax deficiencies.

The pertinent facts with respect to the property transferred have been stipulated and are set forth in our findings, and it would serve no purpose to



reiterate them. The record clearly establishes that the transferor at all times material herein was insolvent.

Under the undisputed facts there can be no doubt that the transferee received property from the transferor while he was insolvent. The value of the property received without adequate consideration is contested. There is also a question as to when the transfer or transfers, as the case may be, became effective. The time element bears only upon the value of the property transferred and has little significance here, as will be developed later.

The petitioner and her husband, the transferor, were residents of Honolulu and were subject to the provisions of the Community Property Act of the Territory of Hawaii, which became effective June 30, 1945. Ch. 301A, sr. D-201, Session Laws of Hawaii 1945. This law was repealed effective June 30, 1949. Ch. 301A, sr. D-296, Session Laws of Hawaii 1949.

The record shows that petitioner's share of the community income for the period June 1, 1945, to June 30, 1949, was \$154,976.51, which would likewise represent transferor's share, making a total community income of \$309,953.02. Petitioner's income tax liability on her community income was in the amount of \$70,289.91. Transferor's income tax liability was not less than that amount, making an aggregate tax liability of \$140,579.82. The total community income of \$309,953.02, less the aggregate tax liability of \$140,579.82, leaves the net community income during the community period of \$169,-

373.20. In 1947 petitioner and her husband caused \$105,000 of their community earnings to be changed into the separate property of each, thus reducing the net community income of \$169,373.20 to \$64,373.20, which was the amount left to take care of the community expenses, including Territorial taxes.

Under the provisions of the Hawaiian community property law, the community property is liable for the debts and liabilities incurred for the protection or benefit of the community property. Ch. 301A, Session Laws of Hawaii 1945, sec. 13(c), (d), and (h).<sup>1</sup> There is a rebuttable presumption that com-

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<sup>1</sup> Session Laws of Hawaii 1945: Chapter 301A. Community Property. \* \* \*

Sec. 13. Property subject to obligations. \* \* \*

(c) The community property shall be liable for debts contracted by the husband or by the wife or by both, and for liabilities of the husband or the wife or both arising out of tort or otherwise, in any transaction entered into or action taken by the husband or the wife or both relating to the management or control or disposition of or other dealing with or for the protection or benefit of the community property. With respect to the liability of community property for such debts and liabilities, no distinction shall be made between community property subject to the management and control of the wife and community property subject to the management and control of the husband.

(d) As between the community property and the separate property of the wife or of the husband the community property shall be liable for the debts and liabilities referred to in paragraph (c) of this section. \* \* \*

(h) Nothing in this section shall be deemed to affect or modify the obligation of the husband to

munity debts are paid out of community funds even though a separate provision requires the husband to support the wife. *Van Camp v. Van Camp*, 53 Cal. App. 17, 199 Pac. 885; in *re Cudworth's Estate*, 133 Cal. 462, 65 Pac. 1041.

The evidence shows that the Santos family consisted of petitioner, her husband, and two minor children, and that they lived in a style and manner commensurate with their income. The Santoses lived in a home with over \$50,000 worth of furniture and operated three late-model automobiles. Their tax returns, which are in evidence, show that during the community period approximately \$9,000 was paid for Territorial income taxes.

We think the reasonable conclusion to be drawn from the evidence is that the community income was entirely exhausted by the payment of living expenses and other community debts. Thus, the respondent has made a *prima facie* case that the transfers in question were made from the separate property of the transferor, and the duty of going forward with the evidence was upon petitioner. *George M. Newcomb*, 23 T.C. 954, 961. Petitioner made no attempt to show the amount of family living expenses during the critical period nor is there any showing that the transferor paid them from his

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support his wife and family and to discharge all debts contracted by the wife for necessities for herself and family during marriage; provided, however, that if and whenever there is community property available for such purpose the husband shall be entitled to resort to such community property rather than to his separate property.

separate property. Reliance is placed upon the fact that the community property law does not relieve the husband of the obligation to support his wife and family. Section 13(h) of Chapter 301A of the Revised Laws of Hawaii 1945, however, provides that the community property may be resorted to for such purpose. See footnote 1, *supra*.

Petitioner argues that one-half the community income became vested in her immediately and that there could be no transfer by her husband of her share. *Rowen v. Commissioner*, 215 F. 2d 641.

This argument overlooks the fact that the community here during the periods in question was still in existence. Until the community is dissolved by divorce or death, the interest of the parties to the community is the profits remaining after the debts of the community are paid. 1 de Funiak, *Principles of Community Property*, sec. 159, pp. 445 et seq.

Petitioner contends that her share of the community income is \$32,186.60. This amount is computed by subtracting the sum of \$52,500, which was transmuted into her separate property by agreement, from the amount of \$84,686.60, which it is stipulated is her share of the community income after her Federal income tax liability. The amount of \$32,186.60 does not take into consideration the liability of petitioner's share of community income for family living expenses and other community debts to which her husband had a right to resort.

In addition to the amount of \$32,186.60 petitioner contends she is entitled to a credit of \$10,000 representing the face amount of a bond retransferred to



her husband, and to a further credit of \$9,957.45 representing the proceeds of her one-half interest in the house sold on April 4, 1950, which was held jointly by her and her husband.

The above amounts aggregate only \$52,144.05, and assuming, for the purpose of argument, the correctness of petitioner's premise, she appears to concede her liability as transferee for a considerable amount, although somewhat less than the respondent has determined.

The respondent concedes that petitioner is entitled to a credit of \$9,957.45, one-half of the net proceeds of the sale of the jointly-held property, which he has taken into consideration.

The evidence establishes that the proceeds of the sale of a bond of the face amount of \$10,000 was applied to the payment of the Territorial income taxes of petitioner and her husband, for which she was jointly and severally liable. Therefore, petitioner is not entitled to a credit for the amount of \$10,000 as a repayment to her husband. The balance of \$32,186.60 we have already held was presumptively exhausted by family living expenses and other community debts properly chargeable thereto.

There remains for discussion the value of the property transferred to petitioner. The record shows that during the years 1948, 1949, and 1950 the transferor purchased cashier's checks in the total amount of \$82,272.67 payable to Lawrence Santos and/or Irmgard Santos. Both petitioner and her husband testified that the checks were given to petitioner at the time of purchase, and she retained



them in her possession until the fall of 1950 when she gave them to her husband for the purpose of purchasing Government bonds. Lawrence purchased U. S. Treasury bonds payable to bearer in the face amount of \$80,000 at a cost of \$81,674.32, and immediately after purchase gave the bonds to petitioner. Whether the transfer was effected at the time the cashier's checks were purchased or at the time the bonds were given to petitioner bears only on the value of the property transferred. After giving petitioner credit for her share of the jointly-owned property in the amount of \$9,957.45, the value of the property transferred would be in excess of the amount of \$68,287.90, as determined by the respondent. On March 27, 1952, the Treasury bonds in the face amount of \$70,000 were sold for \$68,287.90.

Therefore, on this record, we hold that petitioner received a gratuitous transfer of property of the transferor, while insolvent, of the value of \$68,287.90 and is liable as transferee to that extent.

The final issue is whether petitioner has shown facts sufficient to create an estoppel. As to this issue petitioner has the burden.

Petitioner claims that at the time her tax liabilities and those of her husband were under discussion with the revenue agents it was agreed that if she applied the proceeds of the bonds in question to discharge her individual tax liabilities no transferee liability would be asserted against her. The evidence clearly shows that transferee liability was never discussed, but that the agreement related solely to her

individual income tax liabilities. No closing agreement pursuant to section 3760 of the Internal Revenue Code of 1939 was ever executed. If petitioner believed that in discharging her individual tax liabilities she was insulating herself against possible liability as a transferee, she was laboring under a mistake of fact. Petitioner, therefore, has failed to show any basis for the application of the doctrine of estoppel. *Blackhawk-Perry Corp. v. Commissioner*, 182 F. 2d 319, certiorari denied, 340 U. S. 875; *Knapp-Monarch Co. v. Commissioner*, 139 F. 2d 863.

Reviewed by the Court.

Decision will be entered for the respondent.

Murdock, J., dissenting: There are findings that Lawrence gave cashier's checks to the petitioner (mostly during community property years), Lawrence later used them to buy bonds, the bonds in the principal amount of \$70,000 were sold by the petitioner on March 27, 1952 for the total amount of \$68,287.90, the petitioner received checks in that amount, endorsed them, and they were used to pay her individual Federal income taxes for the years 1943 through 1947. The ultimate finding is made that Lawrence gratuitously transferred to the petitioner during the period April 15, 1948 to March 27, 1952, property having a value of at least \$68,287.90, and the petitioner is liable as a transferee to that extent.

I would assume from the above that the holding of transferee liability was upon the theory that sep-

arate property of Lawrence was transferred to the petitioner and used to pay her income taxes.

The giving of the cashier's checks by Lawrence to the petitioner during the period when the community property laws were in effect would appear to be merely the receipt by the petitioner of a part of her share of community property rather than transfers of the separate property of Lawrence. Most of the checks were given during that period. I would not think that any transferee liability would result if the petitioner merely received a part of her share of the community funds during the period when the community property laws were in effect and eventually used those funds to pay her own taxes on her share of the community income.

The transfer of separate property of Lawrence to the petitioner at a time when he was insolvent would, under many circumstances, impress the money in the hands of the petitioner with a trust for the benefit of creditors of Lawrence, including the taxing authorities. However, here the transferred funds were paid to the collector of internal revenue to discharge taxes owed him by the petitioner. It does not appear that she had any other available funds at that time from which she could have paid her taxes. Also it appears that a large part, if not all, of her taxes was due upon her share of community income from the activities of her husband, which income never actually came into her hands. Thus, the Commissioner received the full benefit of the transfer and suffered no detriment by reason of the transfer since but for the transfer he

would not have received payment of the petitioner's taxes. It does not appear that any equity in favor of the Internal Revenue Service would arise under such circumstances.

There is a further complication. The Commissioner determined overpayments of the petitioner's taxes for 1945 and 1946 in the total amount of \$63,005.69, which was less than the \$68,287.90 received for the payment of the petitioner's taxes. But there is no finding that the petitioner actually received the overpayments or of what was done with them or who benefited from them. The Commissioner has the burden of proof to show transferee liability, and it does not seem to me that he has succeeded. Certainly he has not succeeded as to the entire \$68,287.90 unless the burden of going forward shifted at some point not clear to me.

Johnson, J., agrees with this dissent.

Served and Entered June 19, 1956.

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The Tax Court of the United States  
Washington

Docket No. 46327

IRMGARD SANTOS,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

### DECISION

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, filed June 18, 1956, it is

Ordered and Decided: That the above petitioner is liable, as transferee of the assets of Lawrence Santos, for income taxes for the taxable years 1943 to 1946, inclusive, in the amount of \$68,287.90, together with interest as provided by law.

Enter: June 18, 1956.

[Seal]      /s/ C. P. LeMIRE,  
Judge

Served and Entered June 19, 1956.

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In the United States Court of Appeals  
for the Ninth Circuit

Tax Court Docket No. 46327

IRMGARD SANTOS,      Petitioner on Review,

v.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent on Review.

### PETITION FOR REVIEW

Comes now Irmgard Santos, petitioner on review, by her attorney, Robert Ash, and respectfully shows:

#### I.

#### Jurisdiction

Petitioner on review is Irmgard Santos, an individual and an alleged transferee of Lawrence Santos, whose address is 3639 Diamond Head Road,



Honolulu, Territory of Hawaii. The alleged transferor, Lawrence Santos, husband of the petitioner on review, filed his Federal income tax returns for the years 1943 to 1946 inclusive with the Collector of Internal Revenue for the District of Hawaii at Honolulu, which is within the jurisdiction of the United States Court of Appeals for the Ninth Circuit wherein this review is sought.

Respondent on review (hereinafter referred to as "Commissioner") is the duly appointed, qualified and acting Commissioner of Internal Revenue appointed and holding his office by virtue of the laws of the United States.

This petition for review is filed pursuant to the provisions of §§ 1141 and 1142 of the Internal Revenue Code of 1939 and §§ 7482 and 7483 of the Internal Revenue Code of 1954.

## II.

### Prior Proceedings

On October 15, 1952, the Commissioner of Internal Revenue mailed petitioner, as alleged transferee of the assets of Lawrence Santos, a notice of deficiency in which he determined transferee liability against petitioner in the amount of \$68,287.90. Thereafter, the petitioner duly filed an appeal from said determination with the Tax Court of the United States. The case was tried before the Honorable Clarence P. LeMire, Judge of the Tax Court of the United States, in Honolulu, T. H., on July 23, 1954. On June 18, 1956, the Tax Court filed its findings of fact, written by Judge LeMire, and en-

tered its decision ordering and deciding that the petitioner is liable as transferee of the assets of Lawrence Santos for income taxes for the taxable years 1943 to 1946 inclusive in the amount of \$68,287.90, together with interest as provided by law. Two judges filed a dissenting opinion in the case.

Petitioner on review petitions the United States Court of Appeals for the Ninth Circuit to review the order and decision entered by the Tax Court of the United States on June 18, 1956, wherein and whereby it was ordered and decided that the petitioner is liable as transferee of the assets of Lawrence Santos for income taxes for the taxable years 1943 to 1946 inclusive in the amount of \$68,287.90, together with interest as provided by law.

### III.

#### Nature of the Controversy

This proceeding involves the alleged transferee liability of the petitioner, Irmgard Santos, for the income tax liability of her husband, Lawrence Santos, for the taxable years 1943 to 1946 inclusive. During this period, the petitioner and her husband filed separate income tax returns. The Commissioner determined and the Tax Court held that the petitioner was the transferee of the assets of Lawrence Santos in the amount of \$68,287.90. It is the petitioner's position that the Tax Court is in error in determining that the petitioner is liable as transferee of the assets of Lawrence Santos in the amount of \$68,287.90 because there was no transfer

of assets of Lawrence Santos to petitioner. The assets and money involved were the separate property of the petitioner and were used by petitioner to pay her separate Federal income taxes. It is the further position of the petitioner that the Commissioner is estopped from proceeding against her as transferee because of the Commissioner's agreement to apply the proceeds of the assets alleged to have been transferred solely against the petitioner's individual income tax liability.

September 7, 1956.

/s/ ROBERT ASH,

Attorney for Petitioner on Review

[Endorsed]: T.C.U.S. Filed Sep. 7, 1956.

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[Title of Tax Court and Cause.]

### CERTIFICATE

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 18, inclusive, constitute and are all of the original papers on file in my office as called for by the "Designation of Contents of Record on Review" (together with certain documents not called for but included under the rules), including exhibit 1-A attached to the stipulation of facts, and exhibit 2 (petitioner's) and exhibits B to R, inclusive (respondent's), admitted in evidence, in

the case before the Tax Court of the United States docketed at the above number and in which the petitioner in the Tax Court has initiated an appeal as above numbered and entitled, together with a true copy of the docket entries in said Tax Court case, as the same appear in the official docket book in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 14th day of November, 1956.

[Seal] /s/ HOWARD P. LOCKE,

Clerk, Tax Court of the United  
States

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[Title of Tax Court and Cause.]

### TRANSCRIPT OF PROCEEDINGS

District Court. Federal Building, Honolulu,  
T. H., Friday, July 23, 1954.

The above-entitled matter came on for hearing, pursuant to notice to the parties, at 10:00 o'clock a.m.

Before: Honorable Clarence P. LeMire, J., presiding.

Appearances: M. M. Goodsill, Esq., P. O. Box 3196, Honolulu, T. H. E. A. Tonjes, Esq., and R. E. Maiden, Jr., Esq., (Hon. Kenneth W. Gemmill,

Acting Chief Counsel, Bureau of Internal Revenue), for the Respondent. [1]\*

### Proceedings

The Clerk: The appeal of Irmgard Santos, Docket No. 46327.

Will counsel please state their appearances for the record?

Mr. Goodsill: Ready for the petitioner. M. M. Goodsill.

Mr. Tonjes: Ready for the Respondent. R. E. Maiden, Jr., and E. A. Tonjes.

The Court: Are there any stipulations to be filed in this case?

Mr. Goodsill: Yes. If I may, prior to that, I would like to move to file a second amended petition. The petition and amended petition in this case were filed by an attorney by the name of Rogers in California, and he didn't know anything about the case, and it is in very bad form; and I, therefore, have prepared a second amended petition, and I would like to move, at this time, to file it.

Mr. Maiden: There is no objection, your Honor.

I have already prepared the Respondent's answer, which I would like to file concurrently.

The Court: Very well, leave is given to file the second amended petition, and the Respondent is given leave to file an answer to the second amended petition.

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\* Page numbers appearing at top of page of original Reporter's Transcript of Record.



Mr. Goodsill: We also have a stipulation of facts, covering some, but not all of the facts. [3]

The Court: Are there any exhibits attached?

Mr. Goodsill: And there is one exhibit.

Mr. Maiden: One exhibit, your Honor.

The Court: That is Joint Exhibit A-1; is that the way it is marked?

Mr. Goodsill: It is marked Exhibit 1-A.

The Court: Very well, the stipulation, with Exhibit 1-A attached, is received in evidence.

(The stipulation and Exhibit 1-A attached thereto, were thereupon received in evidence.)

The Court: Gentlemen, I would like a brief statement of the facts and issues in the case from counsel for both parties.

Mr. Goodsill: Your Honor, this is a transferee case, the burden of course is on the Government, but I would like to state the facts as well.

The Court: You may state the facts.

#### Opening Statement on Behalf of Petitioner

Mr. Goodsill: This case involves a transferee liability assessed against Irmgard Santos, who is the wife of Lawrence Santos.

The stipulation shows Lawrence Santos owed taxes and penalties for the years 1943 through 1946 in the amount of \$415,427.73.

Additional income tax deficiencies for the years [4] 1943 to 1947 were also assessed against Mrs. Santos, the petitioner in this case. She contested the deficiency but, in April, 1952, she made a payment

of \$68,287.90 to the Collector, which covered the deficiency assessed against her as an individual. She also filed a claim for refund at that time.

Subsequently, her individual case was settled, pursuant to a stipulation filed in this Court, when your Honor first arrived, which is the stipulation attached to Exhibit 1-A to the stipulation of facts here, and that settlement showed that she had overpaid taxes for the years involved in the amount of about \$63,000; so on her claim for refund, she would have that money coming back, plus interest.

However, in October of 1952, the Government sent her a notice of deficiency as a transferee of the assets of her husband, Lawrence Santos, the transferee liability being in the identical amount of \$68,287.90, and interest and costs in the proceedings.

It is my understanding that the Government's contention is that Lawrence Santos transferred to his wife, Irmgard, assets in the amount of \$68,287.90, without consideration, on account of his unpaid taxes.

The stipulated facts show that in the years 1948, [5] 1949 and 1950, Mr. Santos purchased cashier's checks from the Bishop National Bank of Honolulu in the total amount of a little over \$80,000.

I expect to bring out in evidence, this morning, that promptly after he purchased these checks he gave the checks to his wife. These checks were made out in the name of Lawrence Santos and/or Irmgard Santos.

Subsequently, in 1950, those checks were cashed, and United States Government bearer bonds in the

waiian Trust Company, a local trust company was a special partner, holding a 40 per cent interest under a deed by which Mr. Santos transferred certain property to his children.

The validity of that partnership, incidentally, was at issue in her first case, and I believe the Government conceded, for tax purposes, that it was a limited partnership. In any case, when that partnership was created, in 1944, as I say, nothing was given to Mrs. Santos on account of the interest due to her original contribution of capital and the work that she had done for the company. She complained [8] to him at that time that she had not received anything, but she contended and thought that he had not given her recognition of her share in the business.

On June 1, 1945, the Territory of Hawaii enacted a community-property statute, which lasted until July 1, 1949, and as a result of that community-property statute, the earnings and income of the husband and wife, after January 1, 1945, became community property.

On March 1, 1947, Mr. Santos and the Hawaiian Trust Company formed a corporation known as the Manufacturers Shoe Company, Ltd., to take over the assets of the limited partnership. At the time the corporation was formed, Mrs. Santos had to consent to the transfer of the assets from the partnership to the corporation, and she again repeated her claim, saying she had never been given the share, and Mr. Santos assured her at that time that she would be given a share.

At the time the corporation was organized, Mr. Santos got 60 per cent of the stock, and the Hawaiian Trust Company got 40 per cent. However, about a year later, in April, 1948, she requested the auditors of the company to prepare—to make an examination and prepare a statement showing the portion of the earnings of the limited partnership and the corporation, from the time the community-property started, June 1, 1945, until March 1, 1947, when the [9] corporation was organized, for the purpose of showing how much of those earnings, which were community property, Mrs. Santos was entitled to.

The auditors made that examination, and reported as a result of it that she was entitled to \$52,500 worth of the stock. Thereupon, Mr. Santos caused his share to be cancelled and she was given, out of his share, \$52,500 worth of stock.

The point that we wish to make is that the stock was given to her in recognition of her interest in the earnings of the company during her partnership, during the community-property years, June 1, 1945 to March 1, 1947. Nothing was given to her in recognition of her claim of capital contribution and earnings prior to that time.

Well, she was not satisfied with the \$52,500 stock, and continued to make claims on her husband, and he said that, as he got more money, as he got funds, he would give it to her in recognition of her claim of her interest in the old business and her claim for community-property earnings.

Also, in 1950, a home that they owned as joint ten-



ants, and had purchased with the proceeds of the previous home that they owned, was sold, the proceeds of about \$19,000—Mr. Santos kept all that and it is our view that she is—was entitled to a share in that, worth at least \$9,000.

So with that background, in 1948, on several days, [10] and in 1949, on several days, 1950 on several dates, Mr. Santos purchased these cashier's checks in the name of himself, Lawrence Santos and/or Irmgard Santos, and he delivered those checks immediately after purchase to his wife, who kept them.

In November of 1950, Mrs. Santos was on the Coast, where her children were in school. She kept in touch with Mr. Santos here, and they discussed together at that time what they ought to do. She thought she ought to get some interest, so she suggested that she turn the checks in and get Government bonds. She gave him the checks, and he went to the Schwabacher & Frye Company in San Francisco, and with them he purchased \$80,000 bearer Government bonds, and his testimony is that he gave them to her, and he never saw them again, and she will testify that she kept them in her possession from that time until she paid her taxes.

In March of 1952, at a conference between Mr. Santos, his attorney and the Revenue people, and after several conferences and visits by him to the Coast, and telephone calls, he persuaded his wife to turn in her bonds and pay her individual income tax liability, which she did. She sold the bonds in San Francisco on March 27, 1952, and a check for



the proceeds in the amount of \$68,287—the amount was made payable to her in two checks, and she endorsed the checks in favor of Smith, Wild, Beebe and Cades, [11] attorneys in Honolulu here,—sent them to that firm, and they, I believe, deposited them in their trust account, and drew checks for the same amount to the Collector of Internal Revenue for her individual taxes.

She filed a claim for refund in October, 1952, several months after that transaction, and just recently her individual case was settled, and she will get back about \$53,000. Of course, she won't get that back if the Government is successful in this proceeding.

I believe those are the typical facts.

#### Opening Statement On Behalf of the Respondent

Mr. Maiden: If your Honor please, I cannot go along entirely with the delineation of facts as my good friend Mr. Goodsill says them. However, the basic facts are not in dispute.

Our stipulation of settlement shows that Mr. Santos purchased these cashier's checks; that in 1950, those cashier's checks were endorsed by him, and the Government bonds purchased; and then in 1952 those bonds were cashed and the proceeds were made payable to Mrs. Santos, who, in turn, paid them over to the Collector of Internal Revenue, in satisfaction of the tax liability then assessed against her.

The stipulation of facts shows that Mr. Santos was, at all times from 1948 through 1952, hopelessly

insolvent, when consideration is given to the fact that his total assets [12] were only worth—the total value of his assets, if the Court please, were only around \$230,000 at the very most, and his Federal Income Tax liability, and fraud penalties, exceeded \$417,000, or \$427,000.

Now, the Court please, the issue has been clearly stated, and the facts will fall into the record, will speak for themselves. There is no need of my further renumerating the situation.

This question of estoppel raised by Brother Good-sill is, I must say, most unusual, a most unusual thing. I do not understand, if the Court please, that any such representations were made to Mr. Santos or Mrs. Santos, or any of their representatives; and if such representations were made to either of the parties, or their representatives by any agent of the Government, I submit that is wholly irrelevant and immaterial; and not only does the issue in this case, which is whether or not she is liable as transferee of the assets of her husband, in the amounts specified in the statutory notice, but also, if the Court please, oral statements or otherwise, made by agents of the Collector's office here, are not, could not, never would be and are not now binding on the Commissioner of Internal Revenue.

If the Court please, at this time, as an addition, in addition to the stipulation of facts, which has just gone [13] into evidence, I would like to offer the income tax return.

The Court: I take it there is no objection?

Mr. Goodsill: Whose returns?

Mr. Maiden: I am going to offer them both.

Mr. Goodsill: No objection.

Mr. Maiden: I have photostatic copies of these returns for the years involved, your Honor.

Mr. Tonjes: Your Honor, might I make a brief inquiry at the moment?

The Court: You may.

Mr. Tonjes: Mr. Goodsill has stated that certain representations were made by Government officials. The term was used rather loosely, and in order to avoid some delay later, I anticipate that Mr. Goodsill will attempt to put on testimony and establish with whom these conversations were, and I think, in order to avoid delay later, if he could inform us now, we can have these people present, and put them on to controvert whatever testimony there might be,—if the Court permits, of course.

Mr. Goodsill: I was going to examine Mr. Santos, as well as Mr. Cades, and they will testify to their understanding of these matters, I believe. I believe the persons present, as far as I know, were Mr. Alsup, who was then the Collector——

Mr. Tonjes: Mr. James Alsup? [14]

Mr. Goodsill: Yes, and Mr. Robertson, and I believe you were present at some of them.

Mr. Tonjes: I just had in mind the Government officials, your Honor, and I could have them present.

The Court: Yes.

Mr. Goodsill: Mr. Robertson, the Assistant Collector, Mr. Tonjes, Mr. Chun, Mr. Patterson.

Mr. Tonjes: Mr. Chun will be available. Mr.

Patterson is not available, as he is on the mainland.

The Court: Very well.

Mr. Goodsill: I think that is all.

The Court: Is that enough information for your purposes?

Mr. Tonjes: That will be helpful, your Honor. Of course, I have no authority over Mr. Alsup, as he is the former Collector, and he is no longer in the Federal Service, so Mr. Goodsill will be on his own as far as he is concerned.

The Court: Very well.

Mr. Maiden: Now, if the Court please, we offer in evidence, as Respondent's Exhibit B, the 1945 individual income tax return of Irmgard Santos.

The Court: There being no objection, Respondent's Exhibit B will be received in evidence. [15]

(Respondent's Exhibit B was thereupon received in evidence.)

Mr. Maiden: I next offer in evidence, as Respondent's Exhibit C, the 1946 individual income tax return of Irmgard Santos.

The Court: There being no objection, Respondent's Exhibit C is received in evidence.

(Respondent's Exhibit C was thereupon received in evidence.)

Mr. Maiden: I next offer in evidence, as Respondent's Exhibit D, the 1947 individual income tax return of Irmgard Santos.

The Court: Respondent's Exhibit D is received in evidence.

(Respondent's Exhibit D was thereupon received in evidence.)

Mr. Maiden: I next offer in evidence, as Respondent's Exhibit E, the individual income tax return of Irmgard Santos for the year 1952.

The Court: Respondent's Exhibit E is received in evidence.

(Respondent's Exhibit E was thereupon received in evidence.)

Mr. Maiden: As Respondent's Exhibit F, I now offer [16] in evidence the individual income tax return of Lawrence Santos for the taxable year 1945, which is the original return.

The Court: Very well, Respondent's Exhibit F is received in evidence.

(Respondent's Exhibit F was thereupon received in evidence.)

Mr. Maiden: I next offer in evidence Respondent's Exhibit G, the amended 1945 individual income tax return of Lawrence Santos.

The Court: Respondent's Exhibit G is received in evidence.

(Respondent's Exhibit G was thereupon received in evidence.)

Mr. Maiden: I next offer in evidence, as Respondent's Exhibit H, the 1946 individual income tax return of Lawrence Santos, identified as amended return.

The Court: Respondent's Exhibit H is received in evidence.

(Respondent's Exhibit H was thereupon received in evidence.)

Mr. Maiden: I next offer in evidence Respondent's Exhibit I, individual income tax return of



Lawrence Santos for the year 1946, also, identified as completed.

The Court: Respondent's Exhibit I is received in [17] evidence.

(Respondent's Exhibit I was thereupon received in evidence.)

Mr. Maiden: I next offer in evidence Respondent's Exhibit next in order, J, the individual income tax return of Lawrence Santos for 1947.

The Court: Respondent's Exhibit J is received in evidence.

(Respondent's Exhibit J was thereupon received in evidence.)

Mr. Maiden: I next offer in evidence Respondent's Exhibit K the joint income tax return of Lawrence and Irmgard Santos for the year 1948.

The Court: Respondent's Exhibit K is received in evidence.

(Respondent's Exhibit K was thereupon received in evidence.)

Mr. Maiden: I next offer in evidence as Respondent's Exhibit L the joint returns of Lawrence and Irmgard Santos for 1949.

The Court: Respondent's Exhibit L received in evidence.

(Respondent's Exhibit L was thereupon received in evidence.)

Mr. Maiden: I next offer in evidence, as [18] Respondent's Exhibit M, the 1950 joint return of Lawrence and Irmgard Santos.

The Court: Respondent's Exhibit M is received in evidence.

(Respondent's Exhibit M was thereupon received in evidence.)

Mr. Maiden: I next offer in evidence, as Respondent's Exhibit N, the joint income tax return of Lawrence and Irmgard Santos for the taxable year 1951.

The Court: Respondent's Exhibit N received.

(Respondent's Exhibit N was thereupon received in evidence.)

Mr. Maiden: I next offer in evidence, as Respondent's Exhibit O, the individual income tax return of Lawrence Santos for the year 1952.

The Court: Respondent's Exhibit O is received in evidence.

(Respondent's Exhibit O was thereupon received in evidence.)

Mr. Maiden: I next offer in evidence, as Respondent's Exhibit P, the joint return of Lawrence and Irmgard Santos for the year 1952, identified as revised.

The Court: Respondent's Exhibit P received in evidence. [19]

(Respondent's Exhibit P was thereupon received in evidence.)

Mr. Maiden: Your Honor, please, on the basis of the stipulation of facts and the exhibits and the pleadings, the Respondent turns the matter over to Mr. Goodsill.

The Court: The Respondent rests?

Mr. Maiden: Yes, sir.

Mr. Goodsill: If your Honor please, I would like to call Mr. Santos first.

## LAWRENCE SANTOS

was called as a witness by and on behalf of the petitioner, and, having been first duly sworn, was examined and testified as follows:

## Direct Examination

Q. (By Mr. Goodsill): Will you state your name, please?      A. Lawrence Santos.

Q. Mr. Santos, you are a resident of Honolulu?

A. Yes, I am.

Q. What is your occupation?

A. President of the Manufacturers Shoe Store.

Q. You are the husband of the petitioner, Irmgard Santos?      A. Yes.

Q. When were you married? [20]

A. 1928.

Q. At the time you were married, what was your financial condition; in other words, where were you working and what was your income?

A. I was working at the Union Trust Company and was earning about \$175, I think.

Q. That was in 1928?      A. That's right.

Q. What was your job, up to the time in 1937 when you started Persan's?

A. I went from the Union Trust Company to the Home Owners Loan Corporation, and then I was unemployed for a few months, then I formed Persan's Shoe Store.

Q. About how much was your salary at the Home Owners Loan Company?      A. \$200.

Q. Was your wife working, after she was mar-

(Testimony of Lawrence Santos.)

ried?           A. Yes, she worked all of the time.

Q. Where did she work?

A. She worked at the Honolulu Gas Company.

Q. In 1928, until——

A. She was working when I married her.

Q. Do you recall her salary?

A. I think, when we first got married, it was around \$125, and went up to around \$165. [21]

Q. How long did she work at the Gas Company?

A. Until 1941, 'til the war broke out.

Q. At the time you started Persan's, Ltd., did you have any assets, other than the salaries of yourself and wife?           A. No, I did not.

Q. At the time that company was started, how did you get the \$5,000 you put into it?

A. We mortgaged our home up in Manoa; my wife and I owned that home as joint tenants, and I mortgaged it to my uncle, and took the proceeds of \$5,000 and invested it in Persan's, Ltd.

Q. During the time you operated Persan's, Ltd., did your wife work there at all?

A. Yes; she would come in and help out on Saturdays, and whatever extra time she had.

Q. Did she claim an interest in that business?

Mr. Tonjes: I object to that, your Honor, as irrelevant.

Mr. Goodsill: I think it is significant, your Honor, in showing that she had a claim from the beginning of an interest in Persan's, Ltd., and his subsequent shoe business, and that is one of the

(Testimony of Lawrence Santos.)

reasons he made these subsequent transfers of checks, of cashier's checks, to her.

The Court: Well, I think the principal thing is [22] whether she had an interest, rather than what she claimed, but I will overrule the objection and permit the witness to answer, for whatever it may be worth.

Q. (By Mr. Goodsill): Did she claim an interest in the Persan's business?

A. Yes, she did.

Q. You formed a limited partnership on July 1, 1944? A. That is correct.

Q. At that time did you give any—at that time, did you provide that your wife would have any interest in the limited partnership? A. No.

Q. What was her reaction to that?

A. That is when we started having trouble over it, because she felt that she had an interest coming in there, and I had not provided any interest for her, and I had taken care of just the children.

Q. When you organized the Manufacturers Shoe Company on March 1, 1947, did you do anything to give her an interest in that?

A. Yes, I did. She objected to that, there was a bill of sale, or something, that we had to have her sign, and she didn't want to sign the bill of sale, so I told her that I would give her whatever [23] interest she had in the community property, in what Manufacturers Shoe Company had made, and I requested that an audit be made on that.

Q. The community property started in 1945.



(Testimony of Lawrence Santos.)

A. That is right.

Q. What did the audit show?

A. The audit showed that she had \$52,500 of interest during that period, according to the auditors.

Q. During the period of June 1, 1945——

A. June 1, 1945, to——

Q. The corporation was started in March, 1947?

A. To 1947.

Q. That was her interest. How did it arise?

A. It arose from the profits of the shoe company, the Manufacturers Shoe Company.

Q. Did you give her any stock to satisfy her claims or the interest she claimed in Persan's, the operations prior to June 1, 1945?

A. I couldn't then, because my capital was limited, and I just gave her the \$52,500 at that time, which was stock I gave her.

Q. Did you promise her anything else?

A. I promised I would give her cash, as soon as I had it available.

Q. In 1950 you sold your home?

A. Yes, I did. [24]

Q. How was it owned?

A. It was owned as joint tenants.

Q. How much did you get out of the sale of the house?

A. \$19,000—and something, almost \$20,000.

Q. Did you then give half of the proceeds of the sales to your wife?

A. No, I did not.

Q. The stipulation shows that the house was

(Testimony of Lawrence Santos.)

purchased with the proceeds of the sale of the previous houses, going back to the first house you owned on Liliha Street.           A. That is correct.

Q. How did you get the money to pay for that Liliha Street house?

A. That was from our joint earnings.

Q. At the time you were both working?

A. When we were both working. That was purchased around 1932.

Q. How was the title in that house held?

A. It was held jointly.

Q. Joint tenants?

A. My wife and I, yes.

Q. The stipulation also shows, Mr. Santos, that in 1948, 1949, and 1950, you purchased certain cashiers' checks at the Bishop National Bank, the total amount of about \$81,000. [25]

What did you do with these checks?

A. I—as I purchased them, I turned them over to my wife as our agreement. We were having difficulties about financial amounts that she was to have and I told her then that I would start paying her as I could, from month to month, until I could square up with her.

Q. What was this supposed to represent?

A. It was supposed to represent her interest in Persan's and what she had in the Manufacturers Shoe Store, and the rest of the things that she claimed I owed her.

Q. Did you ever give your wife any money or assets other than the \$52,500 in stock, to satisfy

(Testimony of Lawrence Santos.)

her claim for a share in Persan's, or her claim on account of the community earnings, or a claim on account of the proceeds of the sale of the houses?

A. No.

Q. What happened to the cashiers' checks, after you gave them to your wife?

A. In 1950, when I went up to the mainland, we discussed——

Q. Your wife was there?

A. My wife was on the mainland when I went up there. She had gone up before that, I believe in August of 1949, and she was there in 1950 when I got there, and she decided she wanted to get some interest on this share, and I told her [26] that I thought the best investment at that time will be Government bonds, and she agreed that they were, and so——

Q. What did she do then?

A. She turned over the cashiers' checks to me to purchase these Government bonds.

Q. Where did you purchase them?

A. I purchased them at Schwabacher & Frye's.

Q. What did you do then? Did Schwabacher & Frye deliver the bonds to you, personally?

A. Yes. It took about three or four days later, before the bonds were gotten, and when they were gotten, we were called up and I went down and picked them up.

Q. What did you do with them when you picked them up?

A. I turned them over to Mrs. Santos.

(Testimony of Lawrence Santos.)

Q. How long after you picked them up?

A. The same day.

Q. Did you ever see the bonds again?

A. No, I didn't see the bonds at all, with the exception of one bond that I saw in later years.

Q. What bond was that?

A. That was the bond to pay our joint taxes, the Territorial tax.

Q. What was the principal amount of that bond?      A. \$10,000. [27]

Q. The other \$70,000 you never saw again?

A. No, I never did.

Q. You stated that you started having domestic difficulties with your wife in 1944?

A. That is right.

Q. Did you continue to have trouble with her?

A. Yes, we did.

Q. Did she ever leave you?

A. Yes, she did.

Q. When?

A. I think it was around, sometime in 1950, then in 1952, when she filed for separate maintenance.

Q. She filed for separate maintenance where?

A. In San Francisco.

Q. Did she obtain a decree in that case?

A. Yes, she did.

Q. Was service ever made on you?

A. No, because I didn't go into California.

Q. The decree was on the basis of publication?

A. That's right.

(Testimony of Lawrence Santos.)

Q. Has that decree ever been withdrawn, to your knowledge? A. No, it hasn't.

Q. When did Mrs. Santos return to Honolulu?

A. When her daughter was sick in 1953, in [28] December of 1953, I believe.

Q. What finally happened to the \$70,000 worth of bonds which you delivered to her in San Francisco?

Mr. Tonjes: Objected to, your Honor. The witness testified he never saw them again.

The Court: If he knows, he may say so. If he doesn't know, he may so advise.

Q. (By Mr. Tonjes): Do you know?

A. What is the question?

Q. (By Mr. Goodsill): Do you know what happened to the \$70,000 worth of bonds that your wife had in San Francisco, even though you never saw them again?

Q. (By the Court): Do you know of your own knowledge, not what somebody told to you?

A. They were sold to——

Mr. Tonjes: Wait! Do you know? The question is, do you know what happened to them?

Q. (By the Court): Do you know of your own knowledge?

A. Yes, I know what happened to them.

Q. (By Mr. Tonjes): Do you know what happened to the bonds? [29]

A. What is the question?

Mr. Goodsill: I will withdraw the question and start over again.



(Testimony of Lawrence Santos.)

Mr. Tonjes: All right.

Q. (By Mr. Goodsill): In 1951 and 1952, did you have a certain conference, or conferences, with Internal Revenue officials concerning your tax situation? A. Yes.

Mr. Tonjes: That is objected to, your Honor. As I recall, we are not concerned with Mr. Santos' liabilities, except as it forms the basis of the penalties we are seeking to collect here, and counsel has made no allegation that that is inaccurate, in any respect.

The Court: I can't see how it is material in this proceeding, what conversations he had with the Commissioner's representatives in regard to his own taxes.

However, he has already answered the question and I am going to permit the answer to stand, but I don't see any necessity of going into details about it.

Mr. Goodsill: Your Honor, the purpose of this is to bring out the estoppel point, which I have raised in the pleadings, to show that there was some kind of understanding with the Revenue people, as a result of which she paid this money on her individual taxes, the understanding being [30] that she would be allowed to keep anything that she got back as a refund; but what happened was that they turned around and put this deficiency, this transferee assessment on her, they repeated that to her. She never had any conferences with

(Testimony of Lawrence Santos.)

these officials, so I have to do it by means of their recollection.

The Court: I take it that Mr. Tonjes is going to object to the materiality of that testimony, too.

Mr. Tonjes: I would like to briefly express my position, if the Court please.

The question here is whether or not the petitioner received any property or money, or anything of value, under circumstances which would make her liable as a transferee, and the testimony sought to be elicited from this witness is what happened to the property she received, if any, after she received it, and the Respondent contends that is wholly immaterial.

The liability becomes fixed, when she received the particular cash or other assets, and what is done with it I think is wholly immaterial.

The Court: I am inclined, Mr. Tonjes, to be of the opinion that your position is a correct one, but if it is, I can always disregard this testimony, and if I find that, for any reason at all it might be competent I would like to have it in the record.

I will permit the witness to answer.

Do you have something else to say?

Mr. Maiden: Yes, I just want to state, your Honor, that regardless of what representations may have been made to Mr. Santos, or any of his representatives, they are not binding on the Commissioner; it is a fact which, if found by the Court, will have absolutely no relation to the issue falling upon the Court to decide.

(Testimony of Lawrence Santos.)

Now, this is going to take a long time, to go into the testimony of, I understand, several witnesses, to go into this point, which is so obviously irrelevant and immaterial, and, in the final analysis, wholly without any effect upon the decision of the Court, and I submit it is a waste of time that we should not indulge in.

The Court: I am inclined to agree, Mr. Maiden, but on the strength of the fact that I am often mistaken in matters of the incompetency of evidence——

Mr. Maiden: We all are, of course.

The Court: The courts reverse us frequently on the ground of improper exclusion of evidence; so I am going to overrule your objection at this time, and permit the witness to answer, for the reason that I can always disregard it if I find that it is not competent; and if the examination of the witness gets to be too extended I can always stop it.

Mr. Maiden: Yes. If your Honor please, in [32] order to save time, may it be understood at this time, that all questions asked along this line by Mr. Goodsill of any and all of the witnesses are objected to by us?

The Court: Yes, it will be understood that your objections to that time of testimony, and your exceptions will be noted.

Mr. Goodsill: I will try to keep it as short as I can.

The Court: Yes; I suggest, Mr. Goodsill, that you make your examination as brief as possible on

(Testimony of Lawrence Santos.)

that matter because, offhand, I am inclined to believe that the objection may well be taken.

Mr. Goodsill: Thank you.

Q. (By Mr. Goodsill): You had certain conferences with the officials of the Internal Revenue Service in 1951 and 1952?

A. 1951 and 1952, yes.

Q. In those conferences, was there any discussion about these bonds your wife had?

A. Yes. After they had gotten my assets they asked me what more that I could pay towards the taxes, and I said there was nothing else I could pay, but that my wife had some Government bonds, and Mr. Robertson told me—he said to me at the conference, that if it would be possible for me to get those bonds from my wife, and I told Mr. [33] Robertson I did not know, and he then suggested, along with Mr. Alsup and Mr. Tonjes, I believe in one of the conferences, that I go up to the mainland and try to get those bonds from my wife.

I went up to the mainland specifically for that in March—I believe it was March 2nd to March 5, and——

Q. What year?

A. I looked it up and I think it was March 5, March 2 to March 5, 1951, and had a talk with her, and she agreed that she would sell these bonds, if they were to pay her taxes and she would be free and clear.

I came back. We had a conference with Mr. Robertson, Mr. Tonjes and Mr. Alsup and in the

(Testimony of Lawrence Santos.)

interview, when I was interrogated the question was asked me about the bonds. I told them that my wife was willing to pay the bonds to release her tax. Mr. Robertson asked me then, in this interrogation——

Mr. Tonjes: I object to the testimony, your Honor. I think that it should be established that this record is being made subject to a written document of some kind. If it was, I should say that the document, itself, should be offered, rather than Mr. Santos' recollection of what transpired.

The Witness: There is a written document.

Q. (By Mr. Tonjes): Do you have a copy of it?

A. Yes, sir.

Mr. Goodsill: There purports to be a typewritten, unsigned copy of the proceedings on March 27, 1952, which I believe probably was typed by a stenographer in your office, Mr. Tonjes. As far as I know it is accurate, but I cannot establish the authenticity of it. I am willing to put it in evidence, Mr. Tonjes, if you are willing to accept it, and if the Court is.

It purports to be a stenographic transcript of this conference of March 27.

The Witness: Correct.

The Court: It might be, Mr. Tonjes, if we recess for five minutes, to give you an opportunity to look that over, you could obviate the necessity of taking the testimony of these witnesses, and reserve your objection to the competency of the document and its binding effect upon the Commissioner.



(Testimony of Lawrence Santos.)

Mr. Tonjes: I have what I think is a copy that I can compare, if your Honor please. Mr. Robertson is here, and I can give it to him and Mr. Goodsill can proceed, and in a moment or two I will be able to state whether I have any further objection.

The Court: Very well.

Mr. Goodsill: Do you want me to pass to [35] another subject while he does that?

The Court: If you have anything else, yes.

Mr. Goodsill: I have one other subject.

Q. (By Mr. Goodsill): Mr. Santos, when you purchased the cashiers' checks in 1948, 1949, and 1950, gave them to your wife, did you have any idea of what your Federal tax liabilities were?

A. I had no idea whatsoever.

Q. Did you think you were insolvent?

A. No, I did not.

Mr. Tonjes: Objected to, your Honor, as immaterial what he thought.

The Court: The objection will be overruled.

Mr. Goodsill: I think that is all, but I have a couple more questions on this when Mr. Tonjes is through.

Mr. Tonjes: The Respondent will stipulate, if the Court please, that this is a copy, an accurate copy of the transcript of the conference held in the office of the Collector on March 27, 1952.

Q. (By Mr. Tonjes): Is that the date you had in mind, Mr. Santos? Perhaps if you read one or

(Testimony of Lawrence Santos.)

two of the questions, you might recall the circumstances.

A. The question regarding the bonds? [36]

Q. You stated that there was some sort of agreement made. Is that the conference you had in mind?

A. The conference I had in mind was the conference that led up to my trip to the mainland on March 2nd to March 5, and from those conferences on to this one year, when it was agreed on, and I have put in two telephone calls to my wife to go ahead with the sale of those bonds, because of these stipulations that were in this agreement here (indicating).

Q. You referred to an agreement. Do you have any idea in your mind right now as to what date that was?

A. Do you mind repeating that?

Q. Do you have any idea in your mind, now, with respect to the date of the conference, at which the agreement was reached that you speak of?

Q. (By the Court): Was it this conference on this date?

A. It was previous to this date, and also on this date. We had more than one conference or talked about the sale of the bonds.

Q. Was it all included—are all the agreements included in this last conference?

A. Yes, sir.

Q. (By Mr. Goodsill): You had a conference prior to March? [37]

(Testimony of Lawrence Santos.)

A. Right. Mr. Robertson told me if I could go up to the Coast and see what I could do about getting these bonds, and I left specifically on March 2nd for the mainland.

Q. Do you know if there were any written records of those previous conferences?

A. There possibly could be. They had their secretary there, taking notes down, but we never did have anyone. Mr. Milton Cades was present at some of these conferences.

Mr. Tonjes: If I may interrupt, if there was an agreement, it would be expressed in the last conference, wouldn't it? The other conference would be more or less preliminary to that, wouldn't it?

The Witness: They would be preliminary to the extent that that was why I went to the mainland.

Q. (By Mr. Goodsill): When you went to the mainland, you thought that was the understanding that the bonds would be sold and applied to her taxes? A. That is correct.

Mr. Tonjes: Let me then again ask this question.

Q. (By Mr. Tonjes): Do you identify that as a record of the conference held on March 27?

A. I recognize it as being a part of the record, just a part of it. Unfortunately, we do not have [38] the rest of the things in writing. We do have this one in writing.

Q. What else was there, if you recall?

99 A. A telephone call on the 16th of March, and your record will show what date we were down

(Testimony of Lawrence Santos.)

there. I believe you have the record of the days we had our conferences.

Q. (By Mr. Goodsill): I think you misunderstood Mr. Tonjes. I think he wants to know if that is a complete record of the conference on March 27.

A. Yes. I am sorry. This is all we did on March 27, yes.

Mr. Tonjes: Then, subject to the objection of the relevancy of the entire matter, your Honor, I will identify the document as being a correct copy of the conference held on that date.

Mr. Goodsill: I would offer it in evidence, your Honor, as Petitioner's Exhibit No. 2.

The Court: Very well. I am going to receive the document in evidence, overruling your objection, and bearing in mind that if I find it is not competent and binding, I can disregard it. I am admitting it solely for the purpose of avoiding the necessity of the introduction of a lot of oral testimony in regard to what transpired at these conferences.

It is Petitioner's Exhibit No. 2, received in [39] evidence.

(Petitioner's Exhibit No. 2 was thereupon received in evidence.)

[See pages 174-201.]

Q. (By Mr. Goodsill): You said you made some phone calls to your wife on March 26?

A. That is correct, two calls.

Q. What did you tell her in those calls?

A. I told her that we had reached an agree-

(Testimony of Lawrence Santos.)

ment with the Government, and the Government had O.K.'d the release of her taxes, and if there were any refunds to be made, that they would be payable to her through this conference, what I had said under oath to Mr. Robertson and the rest of them there.

Q. Do you know what she did then?

A. Yes; she went and sold the bonds through Burrell & Sons, and had the check made payable to Smith, Wild, Beebe and Cades, and sent it down.

Mr. Goodsill: That is all.

#### Cross Examination

Q. (By Mr. Tonjes): Mr. Santos, your difficulties in tax matters have extended over quite a few years, have they not? A. Yes.

Q. You had a series of conferences with the [40] representatives of the Internal Revenue Bureau, commencing as early as 1950, perhaps?

A. Right after the liens were issued.

Q. That was a jeopardy assessment made against you and the Manufacturers Shoe Company, that was in connection with the matter of collecting sums assessed, which gave rise to these conferences; is that right? A. Yes, sir.

Q. There were several agreements in writing relating to whether the Bureau would proceed to enforce collection, or delay it for some time; do you recall that?

A. Yes, except that I would say the conferences



(Testimony of Lawrence Santos.)

that were held were primarily with the idea of selling me out of the business.

Q. Giving consideration to whether the Government would or would not?

A. That is correct.

Q. Now, in that connection, there were several agreements executed in writing, were there not?

A. Right.

Q. Now, do you know of any agreement, at all, except the one you mentioned just now, relating to your wife's property, had with the Government officials which were not reduced to writing?

A. Do I know of any? I would like the question again. [41]

Mr. Goodsill: I object to the question, your Honor. I think he has already testified that was an oral agreement.

Mr. Tonjes: Yes, but I want to know——

He may so state, if that is true.

Q. (By Mr. Tonjes): You stated that you had an oral agreement with certain representatives of the Bureau? A. Yes, sir; correct.

Q. You also stated that there were several agreements in writing executed with the Bureau?

A. Regarding the selling of the stock.

Q. Yes. A. That's right.

Q. The sale of the stock and the management of your business, and so on? A. Yes, sir.

Q. And they were all reduced to writing?

A. That's right.

Q. Now, were there any other agreements, be-

(Testimony of Lawrence Santos.)

sides this one, which related to your wife's property, that was not reduced to writing?

A. Yes, sir.

Q. Which one was that?

A. Part of it I would say would be the agreement with my wife. [42]

Q. I mean in addition to that, were there any other agreements entered into, which were not reduced to writing, with Government officials?

A. Yes, there were some other things that I can't remember.

Q. What did they relate to?

A. I would have to look at the agreement to tell you what they are.

Q. I mean oral agreements, Mr. Santos.

A. There were other oral agreements that were not put into writing. Is that what you mean, there were others.

Q. Yes.

A. I think Mr. Cades would be able to answer that better than I could.

Q. Do you know?           A. No.

Q. (By the Court): Do you know?

A. No.

Q. (By Mr. Tonjes): Do you know the circumstances which prompted the parties to the agreement to enter into an oral agreement at this time?

A. Do I know the circumstances? Yes, I do.

Q. What were they?

A. That they had gotten all of the money that

(Testimony of Lawrence Santos.)

they could from me and they wanted some more money, that is what prompted the inclusion of my wife into it—her money.

Q. What was the specific agreement? Who said what to who?

A. Mr. Robertson was there present at the time, you were present, and I believe either Mr. Chalk or Mr. Chun was present, Mr. Cades was present, and it was with the understanding that—the question was this: If I didn't get more money, the agreement would be off. We had an agreement one day and it was off the next; it was on the next, and off the next.

Q. What agreement was on and off?

A. The Government agreement that they had with me. We had one agreement with Alsup that we were going to continue and something would come up, and we would have to be called back into conference again, and the thing would be revived over again.

Q. Was your wife's income tax liability ever under discussion in any of these conferences?

A. Yes, definitely.

Q. What phases of it, do you know? Was it her liability as transferee or individually?

A. Her liability as a taxpayer. The transferee [44] came out of the blue sky, I knew nothing about it until afterwards.

Q. Do you know what discussion you had concerning the transferee liability of your wife, if any?

A. What discussions were had?

(Testimony of Lawrence Santos.)

Q. Yes.

The Court: I think he has, in effect, answered that, Mr. Tonjes. He says it came out of a blue sky, and I take it there were no discussions.

Mr. Tonjes: The point is, your Honor,—

Q. (By Mr. Tonjes): Now, had you ever informed any of the Government officials prior to this meeting of—

A. March 27?

Q. —March 27, that you had transferred the sum of \$70,000 or \$80,000 worth of bonds to your wife?

A. Yes, sir.

Q. You had mentioned it prior to that date?

A. Yes, sir.

Q. To whom did you mention it?

A. To the people in the conference, when I was represented by my attorney.

Q. At some time prior to this date?

A. Prior to March 27, yes. [45]

Q. (By the Court): What year was that?

A. 1952.

Mr. Tonjes: This is 1952, your Honor.

Q. (By Mr. Tonjes): Do you know who they were?

A. I would say, by the routine of the conferences that we had, that it would be Mr. Robertson, and whoever the director was, yourself, and Mr. Chalk or Mr. Chun. That used to be a part of the group that was always present. That is my recollection. That is what my recollection would be. You have a couple of other interrogations that were taken of mine and you might find them in there

(Testimony of Lawrence Santos.)

also. We never did get copies of those. That is the only one that we have a copy of.

The Court: We will recess for five minutes while you locate that, Mr. Tonjes.

Mr. Tonjes: Very well, your Honor.

(Thereupon a brief recess was had.)

The Court: Gentlemen, we are going to interrupt the case on trial right now and take up a motion, which we will be able to dispose of in a short time.

(Whereupon the hearing was recessed while the Court took up other matters.) [46]

The Court: Now, gentlemen, we are ready to proceed with the Santos case now on trial.

#### Cross Examination—(Continued)

Q. (By Mr. Tonjes): Mr. Santos, would you please repeat again what you understood to be the agreement made with the Government officials, that you spoke of previously?

A. In conferences with the tax officials, the agreement was that, if I could get my wife to sell these bonds and to pay her deficiency in taxes, she would be relieved of her taxes, which she was, and the release was made. And I was asked if there was any money coming back to her would it be applied on my taxes, and I said no, it would not be, because I had talked to her about it and she had said no.

These were in conferences previous to the March 27th conference. The March 27th conference was an



(Testimony of Lawrence Santos.)

interrogation of me, and had nothing to do with my wife.

Q. In any of these conferences, was there any discussion had with respect to the liability, if any, of Mrs. Santos, as the transferee of you?

A. No, because there was no transferee claimed at that time.

Q. Transferee assessment?

A. There was no transferee assessment.

Q. So whatever discussion you had would not [47] relate to her liability as transferee, as involved in this proceeding here this morning?

A. Well, it related, but it was to clear her of all of her taxes, there would be no——

Q. But now—go ahead.

A. There would be no transferee assessment.

Q. You say there was such a discussion?

A. Not in words, but there would be no transferee assignment, but that she would be liable for no taxes of that type.

Q. Was the word “transferee” ever mentioned, to your knowledge?

A. No, I don't think it was.

Q. Now, at that conference of March 1952, there was some questions and answers—questions propounded by me and you gave the answers, and I will read them to you, to refresh your recollection.

You recall that the purpose of these discussions was to determine whether you had any property which might be subject to taxes, for the satisfaction of your tax liability; is that correct?

(Testimony of Lawrence Santos.)

A. Yes, sir.

Q. Now, the question was:

“Do you have any other evidence of indebtedness?      “Answer: Of indebtedness?

“Question: Yes; does anyone owe you any [48] money? Do you understand the difference between stocks and bonds. Do you own any Government bonds?      “Answer: Yes, my wife’s bonds.

“Question: Your wife’s bonds? Did you give them to your wife?

“Answer: I don’t know how to answer that question.

“Question: What is the name of these bonds?

“Answer: Government bonds.

“Question: How much are they worth; what is the face value?      “Answer: About \$70,000.

“Question: Where are they now?

“Answer: My wife has them and she is selling them.”

Now, are those the bonds that we had in mind at that time, or you had in mind when you answered my questions? Were they the bonds which you spoke of, that were bought from Schwabacher?

A. Yes.

Q. Now, did you mention, at any time, to any Government representative, prior to that date of March 27, that you had given your wife \$70,000 worth of bonds?      A. Yes, sir.

Q. You did?      A. That’s right. [49]

Q. Who did you tell, and where?

A. In a previous conference, prior to March 2,

(Testimony of Lawrence Santos.)

when I went to the mainland to try to get her to sell those bonds. I was told by Mr. Robertson to see what I could do about her selling those bonds.

Q. Do you recall the exact phraseology used in informing him that you had transferred these bonds to your wife?      A. Phraseology?

Q. Yes. How did you tell him? Did you mention the \$70,000, or did you mention Government bonds? Tell us exactly what you told him.

A. I told him that my wife had these Government bonds, and that they belonged to her.

Q. Did you tell him how she got them? Did you tell Mr. Robertson how she got them?

A. No, he didn't ask me about that. He asked me if they were her bonds, and I said yes.

Q. Did you say you gave these bonds to her?

A. I told him that these were bonds that—well, the money that I had given my wife at different times previously.

Q. You told him at that time that you had given your wife \$70,000 worth of bonds?

A. That she had \$70,000. That is why, when [50] I answered your question——

Q. Let's be a little more precise, if we can, Mr. Santos.

Did you tell him at that conference of March, that you had given your wife \$70,000 worth of bonds?

A. I told him my wife owned \$70,000 worth of bonds, yes.

(Testimony of Lawrence Santos.)

Q. Did you tell him that you gave her those bonds?

A. I am not positive, at that time, whether I did or not.

Q. What is your best recollection on that?

Mr. Goodsill: I think he has given that. He says he doesn't remember.

Mr. Tonjes: He might have some recollection of it.

The Court: Let the witness answer the question.

The Witness: That is the answer.

Q. (By Mr. Tonjes): You don't know?

A. I don't remember.

Q. Now, in connection with the acquisition of these bonds, Mr. Santos, when you gave Mrs. Santos these bonds, did you receive any consideration at the time?

Mr. Goodsill: I object to the question, as asking for a legal conclusion.

The Court: The witness may answer if he knows [51] what the consideration was.

Mr. Tonjes: I will rephrase the question, your Honor.

Q. (By Mr. Tonjes): Did you give her anything at the time for the bonds?

The Court: Did she give him anything for the bonds?

Mr. Tonjes: Excuse me.

Q. (By Mr. Tonjes): Did she give you anything of value, at the time you transferred the bonds to her? A. Piece of mind.

(Testimony of Lawrence Santos.)

Q. Nothing of intrinsic value?

A. She laid off of me for a while, yes.

Q. Did you get any money?

A. I told you what I got.

Q. I am asking you whether you got any money?

A. I gave her money. She gave me money? No.

Q. Did you get any property of any kind,—real estate, jewelry, personal property, or anything?

A. No.

Q. So as you understand the word “consideration,” you did not receive any consideration, did you?

A. No, I don't think I received any consideration, as far as money is concerned, or jewelry. [52]

Q. Or anything of value?

A. Not what you consider——

Q. Intrinsic value.

A. Yes; I got a part of this obligation cleared away.

Q. What obligation was that?

A. The money that I owed her, that she contended all of the time for, from Persan's and Manufacturers Shoe Company, that was a bone of contention since 1944.

Q. Did you admit that she was entitled to anything?      A. Yes.

Q. Why didn't you pay her?

A. I couldn't pay her. When we were getting started, we needed all of the capital in the business. That is why, when I gave her the \$52,500, I gave it to her in stock, not in cash.



(Testimony of Lawrence Santos.)

Q. You could have given her a little more stock at that time, too, to settle the obligation, couldn't you?

A. Why would I give her any more stock than I did at that time?

Q. I am asking the questions.

A. Because I still had control of the business. If I gave her much more stock, I wouldn't have the control of the business.

Q. You could have satisfied her demands at [53] that time, if you had wanted to? I am not asking where that would leave you. A. Possibly.

Q. You kept forty per cent of the stock, did you not? A. That's right.

Q. Now, you purchased these bonds at various times. Where did that money come from; was it on deposit in the bank?

A. I don't get the question—where the money came from?

Q. Yes.

A. From bonuses that I got, and from my salary, dividends.

Q. These were monies received from the Manufacturers Shoe Company?

A. That is correct, and from mortgages, or whatever finances I had, and they were paid up, and the money was turned over to me.

Q. You mean mortgages that you had had for some time? A. Yes.

Q. These were your private property?

(Testimony of Lawrence Santos.)

A. Not for some time, but the previous year, yes.

Q. And these were your own private property?

A. That is correct. Most of it was bonuses and dividends and salary. [54]

Q. You stated that Mrs. Santos went to California and sued you for separate maintenance; is that right?

A. That is right.

Q. She is now living here?

A. Yes, she is living here.

Q. Do you live together as husband and wife?

A. We live in the same house.

Q. Where was the first home you bought, Mr. Santos; in Honolulu?

A. Yes. Where was it?

Q. Yes.

A. On Liliha Street.

Q. And when did you buy it?

A. Approximately in 1932, I believe.

Q. And where did the money come from that bought that property?

A. From our joint earnings.

Q. And the title was taken jointly?

A. Yes.

Q. How much of the earnings was yours and how much was Mrs. Santos', if you know?

A. Mrs. Santos used to give me all of her money every month, and I used to run the business—I used to run the expenses, I guess you would call it.

Q. What would you say the ratio of your [55] earnings were, with respect to yours and hers, in the years prior to the time you bought this house?

A. Whatever she earned and turned over to me.

(Testimony of Lawrence Santos.)

Q. How much would you say she earned out of the total?

A. Well, whatever is in the tax return.

Q. How much did you pay for the house?

A. Either \$5,000 or \$5,500.

Q. How much did you pay down?

A. I really don't know. Maybe \$1,000. I don't know.

Q. Would you say that about \$750 was yours and \$250 was your wife's?

A. No, I would say about 50-50.

Q. How do you get at the 50-50 then? Did you earn equal amounts, prior to that time?

A. Fairly close.

Q. And that house was sold and the proceeds invested in another house and that continued right on through until you finally sold the houses in——

A. In 1950.

Q. Is that correct?

A. That is correct. That is the third house, yes.

Q. Was there any additional funds put into the acquisition of these other houses, or did they all follow from the original sale right on through?

A. We bought one, and we sold it. We bought [56] another, and when we sold that we bought another.

Q. Were there additional contributions of cash made in each one of those purchases?

A. Yes, we bought—the third house was more expensive than the first house.

Q. Who put up the additional cash?

(Testimony of Lawrence Santos.)

A. We would always make a mortgage; we would both sign the mortgage, and my wife paid—whatever she earned, she gave to me, and that was applied towards these mortgages.

Q. Did your wife work during all of these periods?

A. My wife worked up until 1941, yes, sir.

Q. Full-time employment?

A. Yes. In between times she had two children. She didn't work when she had the children.

Q. Did you borrow \$5,000 from your uncle for the purchase of one of these houses?

A. Yes, I did.

Q. That was your uncle?           A. That's right.

Q. He gave you the money——

Q. (By Mr. Goodsill): To purchase a house?

A. No, for the purchase of Persan's stock.

Q. (By Mr. Tonjes): Not for the purchase of a house?           A. No. [57]

Q. The \$5,000 you borrowed from your uncle then went to buy the Persan's stock?           A. Yes.

Q. And that money was advanced on your credit, was it?

A. On the credit of my wife and myself. We both signed the notes to my uncle.

Q. Your uncle?           A. Yes.

Q. (By the Court): Was that note paid back out of the proceeds of the business?

A. From our joint earnings.

Q. When you say that, was that from the profits

(Testimony of Lawrence Santos.)

from the business, or did it come out of your joint salaries?

A. I would draw \$250 from Persan's. That is all I would draw from the business. That would go in my checking account. My wife's checks would go in the checking account with mine, and from that we would pay the money to my uncle.

Q. She was still working? A. Yes, sir.

Q. (By Mr. Tonjes): The \$5,000 you say was invested in the stock of Persan's? [58]

A. In 1937, yes.

Q. Now, that stock was all issued in your name, was it not? A. That is correct.

Q. And all of the dividends were paid to you?

A. That is correct, if there were any dividends.

Q. And when Persan's—when was Persan's discontinued? A. I believe in 1942.

Q. 1942? A. 1942 or 1943.

Q. What happened to the assets of Persan's?

A. I transferred them over to the Manufacturers Shoe Store.

Q. The Manufacturers Shoe Store?

A. That's right.

Q. That was operated as an——

A. Individual.

Q. As an individual proprietorship?

A. Yes, sir.

Q. By you? A. Yes, sir.

Mr. Tonjes: I think that is all.

Mr. Goodsill: Nothing further.

The Court: Very well, you may stand aside.

(Witness excused.) [59]



The Court: Gentlemen, we will not be able to conclude this case before lunch time, will we?

Mr. Goodsill: I'm afraid not, your Honor.

The Court: Would you prefer to run awhile longer, or to recess now for lunch and come back, say, at 1:30?

Mr. Goodsill: I have Mrs. Santos here, and it will not take long, and I would like to put her on the stand.

The Court: You would like to put her on the stand now.

Mr. Goodsill: Yes, your Honor.

The Court: Very well.

### IRMGARD SANTOS

was called as a witness by and on her own behalf and, having been first duly sworn, was examined and testified as follows:

#### Direct Examination

Q. (By Mr. Goodsill): You are Mrs. Irmgard Santos? A. Yes.

Q. Mrs. Santos, you were married to Lawrence Santos in 1928? A. Yes.

Q. I believe Mr. Santos stated, that at that time you were working for the Gas Company?

A. Yes, I was. [60]

Q. And you were making about \$125 a month?

A. Around that.

Q. Subsequently increased to about \$150?

A. When I stopped work it was \$165.

Q. You were working there until 1941?

(Testimony of Irmgard Santos.)

A. Yes.

Q. Mr. Santos testified that when Persan's Ltd. was started, a loan of \$5,000 was obtained, and you both signed a promissory note; is that correct?

A. Yes, we did.

Q. And you also signed a mortgage upon your house? A. Yes.

Q. And you signed a mortgage note too?

A. Yes.

Q. You worked at Persan's Ltd. a part of the time?

A. Yes, I would work up there after work and on Saturdays.

Q. When you worked there were you ever paid a salary? A. No.

Q. Were you ever paid anything with respect to the contributions you were making, or may have made to the business? A. No, I was not.

Q. When Mr. Santos created this limited partnership in 1944, did you object to the way the [61] transaction was set up? A. Yes, I did.

Q. Why?

A. Because I felt I had contributed money and time and I should have something.

Q. When he organized the corporation on March 1, 1947, did you have any objection to that?

A. Well, I did. I wanted to be in the business, too.

Q. He arranged to give you out of his stock, \$52,500 worth of stock in the company?

A. Yes.

(Testimony of Irmgard Santos.)

Q. Which was organized on March 1, 1947?

A. Yes, he did.

Q. Did that satisfy your demands for a share of the business?

A. No, I thought I should have more.

Q. You thought you should have more? Did you ask him for more?           A. I did.

Q. What did he tell you?

A. He said that as he could afford it, he would give me more.

Q. (By the Court): How many shares of stock did that involve? I don't believe the record shows that.

A. That was \$10 a share. That would be 5,200.

Q. 5,250 shares?

A. About twenty per cent.

Q. (By Mr. Goodsill): \$10 per share?

A. Yes.

Q. That was supposed to represent your share in the earnings, at the time the community property started?           A. Yes.

Q. That was supposed to represent your share in the community property earnings from June 1, 1941 to March 1, 1947?

Mr. Maiden: Your Honor, please,—

The Witness: From the time—

Mr. Maiden: Just a moment. I object to that, if the Court please. I think that is an improper question, and I think it calls for a conclusion with respect to an issue which is the sole prerogative of

(Testimony of Irmgard Santos.)

this Court to determine, the question calls for a legal conclusion.

Mr. Goodsill: I am just asking her what the stock she got was supposed to be in payment for.

Mr. Maiden: I beg your pardon. I have no objection on that point, because we have that in the stipulation, that the stock was given to her in consideration of her interest in the community income of the business on June 1, 1945, to March 1, 1947.

The Court: Very well. The witness has answered your question, has she? [63]

Mr. Goodsill: She answered the question, yes.

The Court: Very well.

Q. (By Mr. Goodsill): Now, the stipulation of facts in this case shows that Mr. Santos purchased cashiers' checks in the name of himself and yourself in 1948, 1949 and 1950, at various times. Do you know what he did with those checks?

A. He gave them to me as he purchased them.

Q. Totalling about \$81,000?

A. About that, yes, sir.

Q. Why did he give them to you?

A. Well, he said that was my part of the community property, that was part of what I should have from the sale of the houses and my part of the business.

Q. What did you do with these checks?

A. I kept them.

Q. Did he ever give you anything else that was supposed to represent your share of the business?

A. No.

(Testimony of Irmgard Santos.)

Q. Or your share of Persan's?

A. No, he didn't give me anything else.

Q. He didn't give you the stock?

A. Oh, yes, the stock.

Q. \$52,500? A. That is all. [64]

Q. You went to California in the fall of 1950?

A. Yes.

Q. Did you take these cashiers' checks with you?

A. I did.

Q. What happened with respect to the checks then?

A. Well, I just kept them up there.

Q. Was Mr. Santos here at that time?

A. Yes.

Q. Did you have any discussion with him about these bonds?

A. I didn't say I wanted to buy bonds, I said I would like to invest the checks and get some interest.

Q. And he suggested that you buy bonds?

A. He said he thought the best way to invest the money would be to buy Government bonds.

Q. And what happened then?

A. Well, I said that was all right, and I went down to Schwabacher & Frye's and bought the bonds.

Q. What did he do with the bonds?

A. He gave them to me.

Q. What did you do with them?

A. I kept them.

Q. (By the Court): But Mr. Santos made the purchase of the bonds for you? [65]



(Testimony of Irmgard Santos.)

A. He did.

Q. (By Mr. Goodsill): Were you relations with your husband friendly after 1944?

A. No, they were not.

Q. You finally brought an action for separate maintenance? A. Yes.

Q. In 1952? A. Yes.

Q. Mr. Santos has testified that in 1952 he asked you to sell these bonds and turn the money over for the payment of your taxes; is that correct? A. Yes, he did.

Q. Can you tell the Court what the substance of your conversation with him was?

Mr. Maiden: Now, if your Honor please, I object to that. I think Mr. Santos has already covered that, and it is wholly irrelevant and immaterial.

The Court: Well, I think it is pretty well covered, but I am going to overrule your objection at the time.

Q. (By Mr. Goodsill): Will you answer the question?

A. When he came up, he said that if I would sell the bonds that would pay my personal taxes. [66] So I said, well, I didn't know whether to believe him or not, I didn't know what it was all about; so when he came back to Honolulu, he called me twice, and he told me that Mr. Cades had had a conference with Mr. Santos, and they had said that if those bonds were sold that would completely clear me of my taxes.

(Testimony of Irmgard Santos.)

Q. You were willing to turn in the bonds to pay his taxes?

A. No, not to pay his but to pay mine.

Q. To pay your own? You were not going to pay his, but pay your own?

A. That is right.

Q. Who prepared your 1952 tax return?

A. The attorney I had in California.

Q. Who was that? A. Mr. Rogers.

Q. And in that return you made no—claimed no loss on account of the sale of these bonds in 1952?

A. I didn't know what they were worth, or anything, and he prepared the taxes for me and I signed it, and I put myself in a jam.

Q. He didn't know anything about these bonds you sold?

A. He knew that the bonds had been sold.

Q. Mr. Rogers did?

A. Mr. Rogers did, but he didn't put it down [67] in the return; the tax return didn't even mention it. As a matter of fact, I thought the bonds were not taxable.

Q. Were not taxable—even the sale of them?

A. I didn't know.

Mr. Goodsill: No further questions.

#### Cross Examination

Q. (By Mr. Maiden): Mrs. Santos, you testified that you were not on friendly relations with Mr. Santos after about 1950?

(Testimony of Irmgard Santos.)

Mr. Goodsill: 1944.

The Witness: I said in 1944.

Q. (By Mr. Maiden): Did you live with him in 1944 as his wife, up until you went to California?

A. That is right. We were living together as man and wife, but we were not especially getting along.

Q. Were you fighting all that time?

A. Most of the time, fussing, fussing about the money.

Q. Aren't you and Mr. Santos on very good terms right now?      A. At times.

Q. Now, Mrs. Santos, do I understand you to represent here to this Court, under oath, that you always maintained that you had an interest in this Persan's, Ltd., and that you had an interest in the [68] Manufacturers Shoe Company, while it was operated as a sole proprietorship, until until—and that you likewise retain an interest in it after Mr. Santos created the partnership of the business between him and the trust for his children?

A. That was when I said that I was being left out of it. The trust fund did not provide for me, and I had given my money and my time to the business.

Q. In other words, you are telling the Court that you maintain, up through 1952, that you had an interest coming to you out of that partnership and out of the sole proprietorship before the partnership?      A. That I had an interest?

Q. Yes.

(Testimony of Irmgard Santos.)

A. That I claimed I had an interest?

Q. You claimed you had an interest, and you always claimed that?

A. I have always claimed it.

Q. And you now claim it?                      A. I do.

Q. Mrs. Santos, I hand you here what purports to be a copy of a letter on the stationery of the Manufacturers Shoe Store, dated January 5, 1950, addressed to the Internal Revenue Agent in Charge, Post Office Box 421, Honolulu, Territory of Hawaii, and will ask you if that is your signature? [69]

A. That is my signature.

Q. I will ask you if you swore to that?

A. That is my signature.

Q. "Mrs. Irmgard Santos, being duly sworn, says that she has read the foregoing protest, and is familiar with the statement of facts contained therein, and that the facts stated are true."

And you signed that before a notary public?

A. Yes.

Q. Now, Mrs. Santos, I call your attention—I want to read this, your Honor, because it is very brief.

"Under date of November 30, 1949, you mailed to me, Mrs. Irmgard Santos, 1051 Fourth Street, Honolulu, Territory of Hawaii, a copy of your report covering your examination of my income tax return for the calendar years 1946 and 1947, and in your report, you propose to recommend the assessment of income tax deficiencies of \$34,372.73 and \$77,395.95, respectively, for said years.

(Testimony of Irmgard Santos.)

“To your findings I take the following exceptions: You erred in determining that my share of the community income for the calendar years 1946 and 1947 were understated by \$42,353.38 and \$95,814.35, respectively, for said years. The question of whether or not my income was understated for the calendar years 1946 and 1947, depends [70] upon the correct determination of the amount of income earned by the partnership, Manufacturers Shoe Store, for its fiscal years ended February 28, 1946, and 1947, and the correct determination of the amount of income taxable to my husband, Lawrence Santos, a partner.

“Since my interest in the income of the partnership is only my community property interest in my husband’s share of the partnership income, since the issue of whether or not the partnership, Manufacturers Shoe Store, was a bona fide partnership for income tax purposes, and Lawrence Santos Trust, Hamilton Trust Company, Ltd., Trustee, a bona fide partner thereof, since Manufacturers Shoe Store and my husband have both filed protests against your proposed findings, and since the settlement of the issues in dispute in their protest will determine the answer to the exceptions taken by me no brief is being prepared by me except to incorporate herein by reference the facts and arguments contained in the protest filed on behalf of Manufacturers Shoe Store and by my husband.”

Now, Mrs. Santos, you stated in this protest that



(Testimony of Irmgard Santos.)

the only interest you had in that partnership was your community interest. Now, how do you——

Mr. Goodsill: Just a second. I object, your [71] Honor. I haven't heard that before but it seems to me, from the reading of it, that it relates to the partnership years 1946 and 1947. What she is talking about is her interest prior to the organization of the corporation.

The Court: This is cross examination, Mr. Goodsill. You can cover it in your brief and in your redirect examination.

Q. (By Mr. Maiden): Now, Mrs. Santos, why would you make a sworn statement that "since my interest in the income of the partnership is only my community property interest in my husband's share of the partnership income"—why did you make that statement, if you claimed that you had any right to share in the income?

A. Isn't community property— isn't that your right to a share?

Q. Mrs. Santos, I think you have already testified that, when this company was incorporated on March 1, 1947,—and pursuant to your demand an audit was made of the earnings of this business during the time the community property was in effect, from June 1, 1945, up to March 1, 1947, that you, at that time, received stock representing your interest?           A. Yes.

Q. Now, you never considered—you certainly didn't consider, at the time you signed this sworn

(Testimony of Irmgard Santos.)

statement, that you had any other interest in that business, did you? [72]

A. Any other interest?

Q. Yes, than your community property interest?

Mr. Goodsill: She has already testified——

Mr. Maiden: Just a moment, counsel, just a moment!

The Court: Let the witness testify, Mr. Goodsill.

Mr. Maiden: Will you read the question, Mr. Reporter?

(Thereupon, the Reporter read the pending question.)

The Witness: I don't know what you mean. My community property interest was in the business, and my share of the stock. Then I also told you that my husband was giving me the cashiers' checks as a part of my community property, and a part of my interest in the houses in Honolulu.

Q. (By Mr. Maiden): And that is all?

A. That is all.

Q. Now, Mrs. Santos, I want to ask you, is Mr. Santos a pretty good provider?

A. Was he a good provider?

Q. Was he a good provider?

A. Yes, he is a good provider.

Q. I will ask you if Mr. Santos did not maintain you and the family on a standard of living, during the tax years, commensurate with the income he was making? A. Yes, he did. [73]

Q. How many children do you have, Mrs. Santos? A. I have two children.

(Testimony of Irmgard Santos.)

Q. What are their ages? A. 18 and 20.

Q. 18 and 20. Are they married or single?

A. They are both single now.

Q. Didn't you have one or more daughters in a college on the mainland, during 1950 or 1951 or prior to that? A. My daughter was in school.

Q. In school?

A. In 1950 and 1951, she graduated in 1952.

Q. Where did she graduate from, Madam?

A. Castellaya.

Q. Where is that?

A. In Palo Alto, California.

Q. Is that a girls' college?

A. It is a girls' school, it is not a college.

Q. What about the other young lady?

A. I have a son.

Q. A son? What about the boy?

A. He is going to school in San Francisco, and he is living with my mother.

Q. How long has he been there, Mrs. Santos?

A. How long has he been there?

Q. Yes.

A. He has been going to school right in [74] San Francisco for just one year.

Q. Now, Mrs. Santos, when you—when was it that you stated that you left Mr. Santos?

A. I left in August.

Q. Of what year? A. Of 1951.

Q. In August of 1951, you went to the mainland? A. Yes, I did.

(Testimony of Irmgard Santos.)

Q. Where did you get your money to travel onto the mainland?

A. Mr. Santos paid my passage. I was taking the children to school—or, rather, my child.

Q. And he gave you money for you and the children to go to the mainland?

A. The child. I just took one.

Q. And he maintained you and the child while you were in California?

A. No, I was living with my mother while I was in California.

Q. You were living with your mother?

A. My mother and my sister.

Q. Did he furnish you the support and maintenance of the child on the mainland?

A. He paid for the child's school, and he did give me money, but he didn't feel that he could afford to have me take an apartment and still pay for the child's schooling. [75]

Q. In other words, Mr. Santos kept you in such good care—and I don't blame him after seeing you, Mrs. Santos, you didn't find it necessary to use any of these cashiers' checks, in order to get along and pay bills with?

A. I certainly wouldn't have any bills for the amount of the cashiers' checks.

Q. In other words, I take it that the fact that you did not cash them would indicate that you were not in any dire extremities or necessities?

A. No, I was not.

(Testimony of Irmgard Santos.)

Q. You were well maintained, were you not, Mrs. Santos?      A. I was very comfortable.

Q. Now, Mrs. Santos, how many automobiles did you and Mr. Santos own during these years?

A. What years?

Q. Well, from 1941 or 1942, on?

A. 1941, I would say that——

Q. I will shorten it up, Mrs. Santos, and will ask you if it isn't a fact that, at the time you filed your separate maintenance complaint in 1952, you did not allege in that "the community property consisted of the stock of the Manufacturers Shoe Store Corporation held as follows: 40 per cent in the name of the defendant, Lawrence Santos, 20 per cent in the name of the plaintiff, Irmgard Santos, 20 per cent in the name of June Santos, the minor [76] daughter of the complainant and 20 per cent in the name of Bruce Lawrence Santos, son of the parties hereto."

Now, you list the household furniture in the home of the parties, in the City of Honolulu, Territory of Hawaii, of the approximate value of \$50,000; a 1950 Cadillac Sedan automobile, California license issued to the Manufacturers Shoe Store, No. 1 E 33857; one 1950 Oldsmobile Sedan type automobile, registered in Honolulu in the name of the plaintiff; one 1950 Oldsmobile Convertible automobile, registered in Honolulu in the name of the defendant, Lawrence Santos.

Now, Mrs. Santos, would you say that—would



(Testimony of Irmgard Santos.)

you characterize that as indicative of the manner in which Mr. Santos maintained his family?

A. We did have a car on the Coast because he used that for traveling down to Los Angeles, where my daughter was in school at that time.

Q. And when you were on the Coast you used that automobile?

A. Yes, I did use that automobile.

Q. Now, Mrs. Santos, would you characterize Mr. Santos as being very liberal and lavish spender?

A. You mean with his family? Is that what you mean?

Q. Yes, Mr. Santos, on himself, or his family, or both. [77]

A. Well, I guess he does like to spend.

Q. Now, Mrs. Santos, do I understand here—correct me if I am mistaken—that you testified that the only reason you had a falling out with your husband and filed this divorce complaint against him was because he didn't give you what you thought you had coming out of the business?

A. That was part of it.

Q. Was that the main reason, Mrs. Santos?

A. The other reason was that he was very upset during this time, and he did start drinking and gambling, and that worried me quite a bit.

Q. Did you believe he was losing money gambling?

A. I didn't know, but I was afraid he would.

Mr. Maiden: If your Honor please, I do want

(Testimony of Irmgard Santos.)

to offer in evidence, as Respondent's exhibit next in order, Mr. Clerk, the letter of January 9, 1950, which I read into the record.

Mr. Goodsill: May I look at it?

Mr. Maiden: Your Honor, I wonder if I might withdraw it and have a copy made for myself and Mr. Goodsill?

I will see that the Clerk gets it.

The Court: There being no objection, Respondent's Exhibit Q is received in evidence, leave given to withdraw the original and substitute a photostatic copy, or typed copy. [78]

Mr. Maiden: Your Honor, that is a short document, and I am going to let that one stay in, and simply make a copy for Mr. Goodsill and myself.

The Court: All right.

(Respondent's Exhibit Q was thereupon received in evidence.)

Q. (By Mr. Maiden): Just one other thing, Mrs. Santos: I don't want to appear to be insistent, but I want to clear up one thing.

As I understand it you were raising Cain with Mr. Santos about not giving you your interest in the business, as a result of which the auditors made an audit of the books, and determined the community earnings, and you were given stock in the value of your community interest. Why did you accept that if it was not agreeable?

A. The auditors had audited the books, and they said that I was entitled to that amount of money, because of the community property law, that

(Testimony of Irmgard Santos.)

amount of stock. That was my community right in the business.

Q. And you had every confidence in those auditors? A. Yes.

Q. And did you tell the auditors, "Well, now, wait just a minute. I want some more stock here. I have got some more interest in that thing." Did you tell them that?

A. I didn't tell them that. [79]

Q. Mrs. Santos, you say Mr. Santos,—the understanding was that he was giving you those cashiers' checks for some additional interest that you had in the business?

A. He said it was still a part of my interest in the business, it was a part of my money from the Halelea Place house.

Q. When did you sell the Halelea Place house?

A. About in April of 1950.

Q. I believe you did purchase one cashiers' check in 1950. I think the other checks, Mrs. Santos, were issued prior to that time.

A. Prior to 1950.

Q. Yes.

Mr. Goodsill: Excuse me. One in August, 1950 and one in September, 1950.

Mr. Maiden: Yes.

Mr. Goodsill: Two in 1949 and four in 1948.

Q. (By Mr. Maiden): Did you, at that time, have it occur to you as being sort of strange, that Mr. Santos was giving you something for your own;

(Testimony of Irmgard Santos.)

that those cashiers' checks had been made out in his name as well as your own?      A. No.

Q. Did you ask him about that.

A. No. I just thought if it was made out in [80] both of our names, if anything happened to both of us—if anything happened to one of us, the other would get it.

Q. As a matter of fact, that is the only reason why your name appears on those checks, wasn't it, was in case Mr. Santos died?

A. No, I don't think that.

Q. But you didn't feel like there was any Indian gift in that situation, did you?

A. Indian gift, you say?

Q. Yes.

A. You mean that he was going to take it back?

Q. Yes.      A. No.

Q. Why did you consult Mr. Santos about what you would do with your money?

A. Because I have never handled transactions like that.

Q. You had lawyers over there, and other people. Why didn't you talk to them?

A. At that time, when we bought the bonds, I didn't have a lawyer then. I didn't have a lawyer until October.

Q. Mrs. Santos, isn't it a fact that you felt like you had to get Mr. Santos' approval, before you could use any of them? Now, isn't that a fact?

A. No, I don't think I had to get his approval. [81] I didn't know enough about stocks and bonds,

(Testimony of Irmgard Santos.)

and I asked him what would be the best way to invest it.

Q. I am just wondering why you would take up such a conversation with a husband that you had left, and was going to divorce?

A. I didn't know at that time I was going to get a separate maintenance from him. I didn't decide that until October.

Q. I see. I believe that is all. Just a moment.

The Court: We will recess until 2:00 o'clock, gentlemen.

(Thereupon, the hearing was recessed for luncheon, to reconvene at 2:00 o'clock p.m. of the same day.)

#### Afternoon Session

(The hearing was resumed at 2:00 o'clock p.m. pursuant to the taking of the noon recess.)

The Court: Well, gentlemen, you may proceed.

#### IRMGARD SANTOS

the petitioner, resumed the witness stand for further examination.

Mr. Goodsill: Any further questions?

Mr. Maiden: No further cross examination.

Mr. Goodsill: I have several questions, your Honor.

The Court: Very well, you may proceed. [82]

#### Redirect Examination

Q. (By Mr. Goodsill): Mrs. Santos, you, as I understand it, left your husband and went to the mainland in August, 1952? A. Yes.



(Testimony of Irmgard Santos.)

Q. You went there to live? A. Yes.

Q. And you lived there until——

A. I lived there until December.

Q. And during the time that you were there, did he give you any money?

A. At that time he didn't support me at all.

Q. How did you live? A. I went to work.

Q. Where did you work?

A. I worked at Lee-Cardé Dress Shop from September, 1952, until September, 1953, and then I worked with the United Air Lines from September, 1953, until December, 1953.

Q. Did Mr. Santos give you any money, for your own support during that time?

A. No, he did not.

Q. These cashiers' checks, which there has been testimony about, as I understand it they were made out in the name of Lawrence Santos and/or Irmgard Santos; is that correct? [83]

A. Yes, sir.

Q. Either one of you could have cashed them?

A. Yes, we could.

Q. Is it your understanding that you could have taken them, yourself, and cashed them?

A. Yes, I could have.

Q. Without his signature? A. Yes.

Q. When you received this \$52,500 worth of stock in the company, you have stated before that you were not satisfied that that represented the entire amount of your interest? A. Yes.

Q. And you made further complaints to your

(Testimony of Irmgard Santos.)

husband?           A. Yes, I did.

Q. Did you ever see the auditors on this matter?

A. No, I didn't see the auditors.

Mr. Goodsill: That is all.

Mr. Maiden: No questions, if the Court please.

The Court: Very well, you may stand aside.

(Witness excused.)

Mr. Goodsill: Mr. Dunn will be the next witness.

### HERBERT C. DUNN

was called as a witness for and on behalf of the petitioner and, having been first duly sworn, was examined and testified as follows: [84]

The Clerk: Tell us your name, please, Mr. Witness.

The Witness: Herbert C. Dunn.

### Direct Examination

Q. (By Mr. Goodsill): Mr. Dunn, you are a resident of Honolulu?           A. I am.

Q. What is your profession?

A. Certified Public Accountant.

Q. You are a member of the firm of Cameron, Tenne and Dunn?           A. I am.

Q. Did you prepare Mr. Santos' tax return in 1952?

A. It was prepared in our office, either by me directly or under my supervision.

Q. You are familiar with the contents of the return?           A. Yes.

Q. Could you tell the Court the circumstances

(Testimony of Herbert C. Dunn.)

surrounding the preparation and the filing of the return for the year 1952?

A. We had to get an extension of time in preparing the 1952 return, because the properties had been turned over to the Government and sold, we had to get proceeds from the sale of it; and at the same time, we knew that Mrs. Santos was on the mainland, and we suggested—we wrote her, [85] suggesting that she give someone in Honolulu a power of attorney, so we could prepare the return and have it filed. However, a power of attorney was not signed by her, and was returned to us by her attorney by the name of Rogers, stating that he had taken this up with Mrs. Santos and she refused to sign it.

Q. She refused to give anybody power of attorney?

A. Yes, sir. We completed the tax return, and then forwarded the tax return to Mr. Rogers.

Q. This was a joint return?

A. Joint return of husband and wife, and forwarded it to Mr. Rogers, suggesting that he look it over and have the taxpayer, Mrs. Santos, sign it and return it to us for filing.

That return was not signed, was not returned to us. Mr. Rogers wrote to us and said under the circumstances he could not advise his client to sign it.

Q. He was advising his client not to sign the return?

A. That is right.

(Testimony of Herbert C. Dunn.)

Q. Was there anything in the joint return about the sale of Government bonds?

A. There was.

Q. What was that? You are looking now at a copy of the return?

A. Yes, I think it is in evidence. [86]

Q. I believe it is in evidence, yes, the 1952 return.

Mr. Maiden: I think he should refer to the exhibit number so we will know what we are talking about.

Mr. Goodsill: Respondent's Exhibit——

The Court: Mr. Clerk, can you get the 1952 return out?

Mr. Goodsill: We are talking about the 1952 return.

Mr. Tonjes: Is that the one designated as Revised?

Mr. Goodsill: No; as a matter of fact, I think this one is not in evidence; it was never filed. She refused to sign it.

Q. (By Mr. Goodsill): So you are looking at a return there, your copy of the joint return that you prepared and sent to Mr. Rogers?

A. That is right.

Q. What report, if any, was made with respect to the sale of bonds? A. In the——

Mr. Tonjes: Objected to as immaterial, your Honor, if it was never filed.

The Court: I can't see how it is material in

(Testimony of Herbert C. Dunn.)

this case at the present time, Mr. Tonjes. However, I will permit the witness to answer the question.

Mr. Goodsill: I think it will become material.

The Court: You may connect it up, if you can.

The Witness: In the schedule that is attached and is a part of the tax return, the schedule is known as Capital Gains Schedule, in which are listed the sales of the capital assets, and in there is reported two sales, one sale of \$70,000 U. S. Treasury bonds, two and one-half per cent, of the 1967 Series, sold on September 12, 1952, for \$68,-287.90, and also the sale of \$10,000 U. S. Treasury bonds on April 1, 1952, for \$9,739.83.

Q. (By Mr. Goodsill): The sale of the \$70,000 showed a loss?

A. There was a loss of \$1,244.90 sustained on the sale of the \$80,000 par value United States bonds.

Q. Mr. Rogers refused to have his client sign this, and he wrote you to that effect? A. Yes.

Q. What did you do then?

A. We prepared a separate return for Mr. Santos, had him sign it and file it.

Q. What statement was made in there about the sale of the bonds?

A. The same statement—the same bonds were reported.

Q. The same statement as in the previous joint return? A. Yes.

Mr. Goodsill: This (indicating) now, I believe is an exhibit. [88]



(Testimony of Herbert C. Dunn.)

The Witness: Have you the photostat of that return there?

Mr. Goodsill: I am looking. I think we do.

This is Respondent's Exhibit O, the individual return for Lawrence Santos for the year 1952.

Q. (By the Court): Is that the return which you prepared, Mr. Dunn?

A. I didn't prepare it, but it was prepared in our office.

Q. I mean under your supervision?

A. That's right. In the separate return of Mr. Santos, the schedule under Capital Gains was identical with the one in the joint return, except the name is referred to there as the taxpayer, Lawrence Santos, instead of the joint names of Lawrence Santos and Irmgard Santos.

Q. (By Mr. Goodsill): The same schedule?

A. The same schedule.

Q. Can you explain why his individual return reports the loss from the sale of these bonds, which he has claimed were his wife's bonds?

A. We had no knowledge that those bonds were not his, or not owned jointly, or that they were in her name. If I asked the taxpayer—I don't recall [89] asking the taxpayer specifically whether those were his bonds, or her bonds. In obtaining the cost of those bonds, we got that from Schwabacher-Frye statement, which shows a cost of \$80,000 bonds, that account was in the name of Lawrence Santos.

Q. That shows that—the Schwabacher statement shows that he purchased them?

(Testimony of Herbert C. Dunn.)

A. Yes. We probably assumed that those were his. The question, so far as I recall, never came up, and never was denied or admitted, particularly by the taxpayer. Probably that was a failure on my part.

Q. After the joint return came back, you made out the individual return and didn't specifically check that? A. That is correct.

Q. Then subsequent to the filing of the individual return, you filed the revised joint return of Lawrence Santos and Irmgard Santos?

A. No. I am sorry.

Q. Respondent's Exhibit P is the revised joint return of Lawrence and Irmgard Santos, which I believe was filed subsequently, filed in 1954?

A. That is right. At the time we prepared the 1953 return, Mrs. Santos was in Honolulu.

Q. At the time she signed the joint return?

A. That's right, then we prepared the joint return on very much the same basis as it had originally been filed. [90]

Q. The final return for 1952 is a joint return?

A. That is right.

Q. With the same schedule of Capital Gains and Losses, except the title is now Lawrence and Irmgard? A. That is right.

Mr. Goodsill: No further questions.

#### Cross Examination

Q. (By Mr. Maiden): Mr. Dunn, there was not any significance, so far as the reporting of the sale

(Testimony of Herbert C. Dunn.)

of these Government bonds, in the preparing of the joint return to be signed by Mr. and Mrs. Santos, was it? There was not any significance in the fact that you first prepared a joint return, insofar as the bonds were concerned?

A. No, sir.

Q. You assumed that those bonds belonged to Mr. Santos?      A. That's right.

Q. I assume that, when you prepare a return for a taxpayer, you go over that return with the taxpayer to be sure he understands it?

A. Well, I am afraid I couldn't answer in the affirmative on that.

Q. What is your practice, Mr. Dunn, when you prepare returns for taxpayers?

A. Well, I don't try to explain the return to [91] them; I gave up on that, explaining returns to taxpayers. I'm afraid I would fall far short on that. A taxpayer has a right to go over his return and do go over their returns and we change them lots of times, because we have errors in them, but the returns are made from information submitted to us by the taxpayer, and if we have no reason to believe they are wrong, we use that information in the return.

I wouldn't make it a point to go down, item by item, and say, "Have I done this right?"

Q. Well, did you present the return to Mr. Santos, to have him sign it?      A. Surely.

Q. Did Mr. Santos look over the return?

A. I couldn't answer that.

(Testimony of Herbert C. Dunn.)

Q. Well, since you prepared the return on the basis of the information given you by Mr. Santos,—Mr. Santos told you about these bonds, the sale of them in 1952? A. That's right.

Q. Now, you spoke about subsequently filing the revised 1952 joint return, which I believe you testified, at that time, Mrs. Santos was willing to sign the joint return.

I will ask you if this isn't the fact, Mr. Dunn: That the purpose of filing the revised return, under a special provision, I believe, sir, of the Internal Revenue Code then in effect,—if the purpose was [92] not to gain additional tax benefit?

A. Surely.

Mr. Maiden: That is all.

Mr. Goodsill: No further questions.

The Court: Very well, you may stand aside.

(Witness excused.)

Mr. Goodsill: Mr. Cades.

### MILTON CADES

was called as a witness for and on behalf of the petitioner and, having been first duly sworn, was examined and testified as follows:

The Clerk: Tell us your name, Mr. Witness, please.

The Witness: Milton Cades.

### Direct Examination

Q. (By Mr. Goodsill): Mr. Cades, you are a resident of Honolulu? A. I am.

(Testimony of Milton Cades.)

Q. What is your profession?

A. Attorney-at-law.

Q. You are a member of Smith, Wild, Beebe and Cades?      A. I am.

Q. Were you employed as counsel for Mr. and Mrs. Santos in connection with their tax problems?

A. I was, yes.

Q. When did this employment start? [93]

A. I believe the employment started on January 15, 1952.

Q. What were the circumstances under which you were employed?

A. Mr. H. W. B. White, the Vice-president of the Hawaiian Trust Company, requested us to represent the taxpayer in this particular case, that is, Lawrence and Irmgard Santos, because the Government had issued a distraint order and had advertised for sale the stock of the Manufacturers Shoe Company that was owned by the two of them.

Hawaiian Trust, as trustee of the trust created for the benefit of the children of the Santos, owned the other stock.

Q. Hawaiian Trust Company owned forty per cent?

A. Forty per cent, and the Trust Company was interested in seeing that the control of the stock was not put on the market and possibly destroy the trust's investment in the business, and it was on that basis that we agreed—Mr. Beebe, one of my partners, was in the conference with Mr. White. We



(Testimony of Milton Cades.)

consulted our other partners, and we agreed to accept the engagement.

Q. Now, then, at that time, the Government was threatening to put up for sale the stock in the Manufacturers Shoe Company owned by Mr. and Mrs. Santos?

A. Yes. My time sheet shows that the same day we [94] started——

Mr. Maiden: Wait just a minute. If the Court please,—excuse me, Mr. Cades,—your Honor, please, I object to the use of the words by Mr. Cades of threatening. The Government doesn't threaten anybody, and I move that that be stricken from the answer.

The Court: Well, I think the Court understands the witness, and I advise counsel for the petitioner to watch his adjectives and adverbs, and so forth.

Q. (By Mr. Goodsill): The Government proposed to sell them?

A. The same day that we were engaged, we requested Mr. Shoddy, an associate in our office, to do some legal research on the right of the taxpayer to enjoin the levy and sale under award of distraint, issued pursuant to jeopardy assessment, prior to a 90-day letter.

Q. The purpose of this was to prepare possibly to enjoin the Government from carrying out the proposed sale?

A. That is correct. As the first step in discussing the matter with the Government we wanted to know what the rights of the taxpayer were.

(Testimony of Milton Cades.)

Q. Did you have some conferences with officials in the Bureau?

A. The next day, the 16th, we had a conference, Mr. Beebe of our office, Mr. Santos, Mr. Dunn, Mr. Robertson, [95] Mr. Chun, Mr. Tonjes were all present,—at which time I informed them of the legal research that we were conducting, and requested that the sale be delayed until such time as it was determined whether there was any tax liability, at all, of the taxpayer.

Q. Did you discuss any agreement with respect to the operation of the shoe store, or the sale or non-sale of the stock?

A. Yes, we did. Immediately, our discussion got into the question of the terms under which the Government would be willing to postpone the sale, and it had to do, primarily, with what monies could be immediately paid, and what protection the Government would have over the business, to see that it was not—that funds were not taken that might otherwise go in payment of taxes.

Q. The Government was asking questions about the assets that were available for the payment of taxes?

A. That is correct, and I recognized, of course, that in asking the Government to give up any rights to immediate sale of the property, that the Government had to be secured, to be sure that they would not lose any of their rights to collect.

Q. Did this question involve property owned by Mrs. Santos, as well as Mr. Santos?

(Testimony of Milton Cades.)

A. Yes, it did. We were discussing all of the [96] property owned by both taxpayers.

Q. Were you discussing her tax liability as well as his?

A. Yes. I was retained by her, and had a power of attorney to represent her.

Q. Were there subsequent conferences to the one you have mentioned?

A. My records show that after the 16th, I telephoned Mr. Tonjes and——

Q. The 16th of January?

A. That is on the 18th of January. On the 22nd of January, I telephoned Mr. Robertson. On the 22nd, we completed a draft of a complaint in an injunction action to restrain the sale of the stock; and on the 23rd, we had a conference, at which the draft was shown to the Government representatives, to show that we felt that we had a right to enjoin the sale. It was an attempt to make them realize that we would not permit the sale of the stock to go on before a determination of the tax liability, if we could avoid it, and that conference was attended by Mr. Beebe, Mr. Santos, Mr. Condon, who is a partner in Cameron, Tenne & Dunn, Mr. Dunn, Mr. Tonjes, Mr. Robertson, Mr. Alsup, who was the Collector at that time, and Mr. Chun.

Q. What was the result of that conference? [97]

A. As a result of that conference, it was suggested that we get together with the Agent in Charge of the office, to see if we could work out some compromise of the tax liability, so that, if it

(Testimony of Milton Cades.)

were determined exactly what the liability was, we could then make some agreement to settle the amount of the tax liability.

Q. Then you made an effort, and did you get together with the Agent's office?

A. The next day, the 24th of January, Mr. Santos, Mr. Dunn and myself, had a conference with Mr. Jansen, at which we explored the possibility.

Q. What was the result of that conference?

A. The result of the conference was that I believe that Mr. Jansen was going to let us know whether anything could be done. He expressed great doubt as to whether the collection end had anything to do with the assessing and of the service.

Q. What was the final result of that effort?

A. Well, on the 30th, we had another conference, with Mr. Jansen, at which that was confirmed. At that time, we agreed that there was nothing that could be done at that time to determine the liability.

In the meantime, on the 28th, we had been requested to submit to the Collector a proposal, setting out what we would do, what we could offer by way of payments and what [98] other commitments we could make, in order to get the Government to hold up the sale of the stock.

Q. They had requested you to submit a proposal?

A. That is correct, and I telephoned Mr. Robertson when it was ready, and the next day we met, on the 29th, at which time we presented the proposal.

Present at that conference was Mr. Santos, Mr.

(Testimony of Milton Cades.)

Robertson, Mr. Tonjes, Mr. Dunn, and Mr. Alsup.

Q. Did that proposal contain anything about Mrs. Santos' property?

A. As I remember—and I have a number of drafts—all of these agreements had to do with the payment of certain monies to the Government and where the funds would be obtained.

They also had commitments on the part of Mr. Santos to turn over to the Government his stock in the Manufacturers Shoe Company, and other securities that he had, and to try to procure from Mrs. Santos, and turn over to the Government, her securities.

Q. Was Mrs. Santos to be a party to the agreement?

A. She was to be a party to the agreement, and there was a provision for her agreement.

Q. Then it contained the provision that she was to turn over her property also?

A. That is correct. Somewhere in our discussions, [99] it became apparent that *Mr.* Santos was not going to go along with this, and the tenor of the drafts changed, as I reviewed them, to Mr. Santos' undertaking to try to get the securities.

Q. It became apparent that she would not——

A. That she was not satisfied to turn over her securities to the Government.

Q. She was asked to turn over her securities on his obligation?

A. Well, for their joint obligation, or for the total obligation.



(Testimony of Milton Cades.)

Q. And there were further conferences concerning this agreement?

A. Yes. The Government re-drafted our agreement, and suggested certain changes, and on February 4th, I re-drafted again the letter of proposal and delivered it to Mr. Robinson.

On the 5th I telephoned both Mr. Robinson and Mr. Tonjes about the agreement and on the 6th, again, and at that time, somewhere around that time it was acceptable, and——

Q. The agreement in final form was acceptable in February?

A. Some time around that date, in early February, and it provided, as I recall, that Mr. Santos was to settle [100] his mother's estate as quickly as possible, and turn over the assets of that estate to the Government. He was also to see Mrs. Santos about——

Q. Who was then in California?

A. Who was then in California, and to see what he could do about getting her securities turned over to the Government; and also the question came up of the bonds which were in her possession.

Q. When did this question first come up?

A. That question came up—my memory is that it came up before Mr. Santos went to the Coast. That was one of the things that he was going to do, was to get that money.

Q. He testified that he went to the Coast, I think, about March 3rd or March 4th, or there-

(Testimony of Milton Cades.)

abouts. Your memory is that the question of the bonds came up before that time?

A. Yes, that is correct. I have it here on—on the 15th I telephoned Mr. Robinson.

Q. The 15th of March?

A. Of February, which was, I believe, an inquiry as to what progress Mr. Santos was making, and at which time he told me of his plans for going to the Coast.

Q. You told Mr. Robinson that Mr. Santos intended to go to the Coast, to try to get these bonds?

A. That is right. As a matter of fact, it is my memory that the Government was quite anxious to have him [101] go up there, because his mother's estate could not be settled until he went up there, there were certain matters that he had to discuss with the attorney for the estate.

Q. Following the February 15th conference, did you have another conference?

A. The next I have is on March 25th, at which time I telephoned Mr. Tonjes.

Mr. Santos had returned, and had said that Mrs. Santos was unwilling to turn over the stock, or any of her money, except in payment of her own tax liability.

Q. She was not willing to turn over the bonds?

A. She was not going to turn over any money, which had to do with the bonds, except in payment of her own liability.

Q. You told that to Mr. Robinson?

A. That was told to Mr. Tonjes, and at that

(Testimony of Milton Cades.)

time, the matter was discussed as to whether the Government would accept the payment for her liability and release her from the lien.

Q. What time was this? What date was this?

A. That was in March, about the 25th.

Q. About the 25th of March? A. Yes.

Q. And what was the result of that? Was there an understanding, at that time? [102]

A. There was an understanding and that was a computation as to how much would be required, and it is a little complicated, but possibly I can explain it this way:

The original jeopardy assessments were for approximately \$190,000 against Mrs. Santos. Within 60 days after the jeopardy assessment, a 150-day letter was issued, a real deficiency, in which there was a shift of years for which the tax liability was determined, that arose by reason of disallowing the partnership, which was on a fiscal basis, as a bona fide partnership, and converting all of the income to the calendar year basis, on the theory that it was still Mr. Santos' business, and he had no right to convert to the fiscal year basis. The result was that the liability was shifted from year to year, and although the total liability was approximately the same, the liability for the years which were under lien required the payment of approximately \$68,000 to satisfy the lien.

Now, those figures were worked out with Mr. Robinson. The figures were given to us, and we were told exactly how much money Mrs. Santos would

(Testimony of Milton Cades.)

have to pay to discharge the lien for her taxes.

Q. And it turned out that she would have to pay about \$68,000?

A. Yes, that is right. That is the figure that was [103] given.

Q. And that was about the 25th of March?

A. That was about the 25th of March.

Q. Then do you know what happened on the 26th of March?

A. On the 26th of March, I had a conference with Mr. Santos, who informed me that he had spoken to his wife, that she wanted my assurance that if this money was paid, it would be in discharge of her liability; and that if it were determined that she did not owe any money, she would get that money back.

Q. It was thought at that time that she would file a claim for refund?

A. It was thought of, yes, and was spoken of.

Q. The possibility that she would get something back?

A. That's right.

Q. Her understanding, as far as you know, was that if she got something back, she would be able to keep it?

A. That is correct.

Q. Was there a conference subsequent to that?

A. On March 27, I attended a conference at which, in accordance with the agreement that had been made previously, Mr. Santos agreed to subject himself, under oath, to examination as to the financial condition of himself [104] and Mrs. Santos.

The Government had been asking for a written

(Testimony of Milton Cades.)

financial statement. Mr. Santos felt that there was such uncertainty as to what the value of the assets of his mother's estate was, what he would realize, that he was afraid to make any errors in the statement; and on the basis of that, he preferred not to sign a financial statement.

We discussed that, and the Government was satisfied to ask questions as to his financial status, in lieu of signing a financial statement.

Q. At this meeting on the 27th, was there any further discussion about the bonds of Mrs. Santos?

A. There was. At that time, we informed—present at that conference were Mr. Tonjes, Mr. Robinson, Mr. Alsup, Mr. Patterson and Mr. Chun, before Mr. Santos was sworn, we discussed the problem——

Q. Before he was sworn in?

A. Before he was sworn in and interrogated, the assurance which I had given Mrs. Santos was explained, that this money had to be used for her taxes; that if it were determined that she was not liable, it was to be refunded to her, and that was all satisfactory before——

Q. Before the interrogation started? [105]

A. Before the interrogation started.

Q. Do you recall whether in the interrogation itself there was any further discussion about the bonds?

A. During the interrogation, there were a number of questions which indicated prior knowledge in the questions. I recall a question by Mr. Robinson



(Testimony of Milton Cades.)

as to whether Mrs. Santos would agree, if there should be a refund,—whether she would agree to apply it on the taxes of Mr. Santos, and I explained that that was not in accordance with my understanding with her; I believe I said she would not agree to that, and so informed him.

Q. I have here Petitioner's Exhibit 2, which is the stenographic report of the sworn interrogation on that date. I will read this, and ask you if it is in accordance with your recollection.

“Mr. Robinson: In the event Mrs. Santos' taxes are paid in full and she can file a claim for refund, would she be willing to turn it over to us?

“Mr. Cades: I understand she will not.

“Mr. Santos: I tried to work that.

“Mr. Cades: I understand that this business of dividing community property is something she has insisted on.

“Mr. Alsup: She has that right.

“Mr. Cades: She has that right, according to law. [106] She got hers out of that, and she was not going to let it go.

“Henry: Are you satisfied?”

Who was “Henry”?

A. Mr. Robinson.

Q. Is that in accordance with your recollection?

A. Yes, that is what I had reference to.

Q. Do you recall whether there was any discussion after this one? Stopped at 11:50 a.m.,—if there were any further discussions?

A. Well, very few of our conferences ever ad-

(Testimony of Milton Cades.)

journed when the formal talks ended. We usually talked various things over with the various persons present, and on a number of occasions I would walk down with different people, and I know Mr. Santos still did continue the conversation with regard to it.

Q. Do you recall any further conversations after that conference?

A. As I recall, this conference ended with a request to get the money in as quickly as we could, and get it paid up and settled.

Q. Then you subsequently did get the money in from Mrs. Santos?

A. We received a check from a San Francisco brokerage house on April the 2nd and we telephoned Mr. Alsup. I [107] telephoned Mr. Alsup that I had the check, and made an appointment for the next day to deliver the check. We turned the check into our trust account, and issued the firm check for the amount of the tax.

Q. And that was delivered on what date?

A. That was delivered on April 3rd at a conference at which Mr. Santos was present, Mr. Robinson, Mr. Alsup, Mr. Chun, Mr. Patterson and Mr. Tonjes.

Q. Was there any further discussion about this matter of the wife's property?

A. Well, at the time that this was done, I believe it was Mr. Patterson who undertook to have the lien released immediately and we did get a number of receipts. I believe Mr. Robinson took care of

(Testimony of Milton Cades.)

that, or had somebody make out the receipts for the payment.

Q. Was the lien subsequently released?

A. Either the same day or the next day. It was very closely thereafter.

Q. As to this transferee assessment of October, 1952, were you consulted with respect to that?

A. Before October of 1952, Mrs. Santos had written to me, saying that she had engaged other counsel in San Francisco, by the name of Rogers, and she asked me to withdraw as counsel.

My brother, J. Russell Cades, was also [108] entered as counsel, and my then partner, Irving Wild, was also entered as counsel. He had died a short time before, and I filed a withdrawal of counsel on behalf of myself and my brother, and filed a suggestion of death of Mr. Wild, and sent those to Mrs. Santos and Mr. Rogers.

Q. Mr. Rogers then represented Mrs. Santos?

A. That is right. Some time after that, I was consulted by Mr. Santos, who had received at his home the transferee liability—the transferee assessment against Mrs. Santos.

Q. The notice?

A. The notice of the transferee deficiency, and asked me about it, and I——

Q. Asked you what to do with it?

A. That's right, and I suggested that he send it to Mrs. Santos, because I was no longer authorized to act on her behalf.

(Testimony of Milton Cades.)

I did, however, call on Mr. Alsup, to tell him what a dirty trick I thought it was.

Mr. Maiden: If you Honor please, I object to that.

The Court: That part of the answer will be stricken.

Mr. Goodsill: I think that is all. [109]

### Cross Examination

Q. (By Mr. Maiden): Mr. Cades, at the time you were having these conferences with the various representatives of the Collector's office, now the Director, in regard to the bonds which Mrs. Santos had, was there anything said about how Mrs. Santos got those bonds?

A. Yes, there was. It is my recollection, just in the short passage that Mr. Goodsill read, that they had been previously discussed. I refer to the section where I said Mrs. Santos had received the bonds and insisted on her right to them, and Mr. Alsup agreed to that.

Q. You said received the bonds. Did you make it clear that those bonds came from money which Mr. Santos had given Mrs. Santos?

A. Well, I don't just know what words were used, but I didn't have the slightest doubt that somewhere in the discussion the Government representatives knew exactly all about those bonds. I think there was a discussion that the bonds had been bought, and the account of Schwabacher & Frye showed they were purchased by them.

(Testimony of Milton Cades.)

Q. Now, Mr. Cades, at any time during any of these discussions, did any representative of the Government tell you that, if Mrs. Santos would turn over these bonds in settlement of her own tax liability, that she would not be held liable as transferee of Mr. Santos?

A. I don't think there was any question [110] at any time of the transferee liability discussed. However,——

Q. Just a moment, Mr. Cades. I have my answer, sir. A. May I explain the answer?

Q. If counsel desires you could do so, you may.

Mr. Goodsill: Your Honor, may he explain the answer?

The Court: Yes, he may explain it.

The Witness: My answer means that the word "transferee liability" was not used. However, our discussions indicated that there was full liability in any capacity, because,—if I may explain the reason for that—we were talking about the sources of the bonds, and it was quite apparent that we were both thinking about the same thing, although he did not mention it in particular words.

Q. (By Mr. Maiden): You were talking about her individual tax liability? A. Yes.

Q. Mr. Cades, as I understand it, we had a jeopardy assessment against Mr. Santos, at that time, didn't we, sir?

A. At that time, in April, no. In April there was—In April the 150-day letter had already been issued. The jeopardy, as I recall, was issued at the



(Testimony of Milton Cades.)

end of December, and the 150-day letter was sent out some time before the end of February; it would have to be, to be valid.

Q. Now, Mr. Cades, I am just wondering, [111] sir, if the Government knew that Mrs. Santos had these bonds and the Government, at that time, had these tax liabilities asserted against Mrs. Santos, would you please tell me how Mrs. Santos would have any bargaining power with the Government, with respect to turning over the bonds in satisfaction of her liability?

A. Well, let me put it this way:—

Q. Just one second, sir.

A. Are we arguing law or are we—

Q. No, we are not arguing the law. I am simply stating this:

How could Mrs. Santos withhold those bonds from the Government, in satisfaction of her own liability, if she was claiming ownership of the bonds?

A. Mrs. Santos was not in Honolulu and I did not have the benefit of advising her as to what her rights or liabilities were.

Q. But the argument with the Internal Revenue law in Hawaii doesn't—doesn't that extend over into California?

A. I think it does, yes, But physically—let me say this about that, that the Government had issued an order directing Mrs. Santos to produce all of her securities and turn them over to the Government. As far as I know that was not served on her in any proper manner that could bring her before the Director. [112]

(Testimony of Milton Cades.)

Q. The first you knew about the assertion of the transferee liability was when Mr. Rogers showed you the transferee notice in Mrs. Santos' case?

A. No, when Mr. Santos did.

Q. Oh, Mr. Santos advised you of the fact that Mrs. Santos had told him?

A. I don't recall how we received the information, but I believe he received it at his home, it was addressed to his Honolulu address.

Mr. Maiden: May I have just a second, if the Court please?

The Court: Yes.

Q. (By Mr. Maiden): Now, Mr. Cades, I will ask you sir, did you represent Mrs. Santos in her own individual case, which was docketed on this calendar? A. I did until sometime in 1952.

Q. I am talking about her own individual case.

A. That is what I was talking about too. I withdrew from that at the request of Mr. Rogers.

Q. I am asking you, sir, if you did not represent her at the time her individual tax case was called before this Court?

A. Yes, I did. I might explain that in February of 1954, this year, I was in San Francisco, at [113] which time Mrs. Santos had discontinued the services of Mr. Rogers, and had a Mr. Paul May representing her, and Mr. May asked me to turn over what material I had to him for the trial of the case. At that time,—

Q. Let's bring this to an end, sir. I appreciate your interest in the matter.

(Testimony of Milton Cades.)

I will ask you if it isn't a fact—didn't the Government make a stipulation with Mrs. Santos, in her individual case, ordering the over-payment to her of the amount which she had paid on her taxes.

A. Yes, but I was——

Q. Now, just a second. Now,——

A. Now listen——

Q. Now wait just a second. I asked that question——

The Court: Answer the question, Mr. Cades.

Mr. Maiden: He answered the question. That is it. That is all, your Honor please.

### Redirect Examination

Q. (By Mr. Goodsill): Mr. Cades, with respect to this matter that was brought up and you were about to explain your answer——

A. Well, as a result of my discussion with Mr. May in San Francisco, in February, 1954, it was determined by Mr. May that Mrs. Santos' interest was exactly like Mr. Santos', in the determination of the amount of her tax liability; that it only resulted from her community interest [114-115] in his income, and at Mr. May's recommendation, Mrs. Santos asked me to complete the settlement with the Government of her tax liability in the same manner as I had done for Mr. Santos. It was a formal matter. The amounts were mathematical, and it just involved the signing of a stipulation.

Q. Mr. May recommended that to Mrs. Santos?

A. That is correct.

(Testimony of Milton Cades.)

Mr. Goodsill: I think that is all.

Mr. Tonjes: This might be a bit irregular, but will counsel permit me to interrogate the witness?

Mr. Goodsill: Very well.

Mr. Tonjes: This is a matter I happen to be familiar with.

Q. (By Mr. Tonjes): Mr. Cades, I show you a letter dated April 23, 1952, which was addressed to Mr. Lawrence Santos, and it is signed by J. M. Alsup, and has a notation of approval by Lawrence Santos, and I will ask you if you have seen that document before?

A. I am afraid I don't recall.

Q. You don't recall ever having seen it?

A. I do not, no.

Mr. Tonjes: I have no further questions.

The Court: No further questions? [116]

Mr. Goodsill: No further questions.

The Court: Very well, you may stand aside, Mr. Cades.

(Witness excused.)

Mr. Goodsill: I have no further witnesses.

The Court: Any testimony for the Respondent?

Mr. Tonjes: I would like to recall Mr. Santos very briefly, your Honor.

The Court: Very well, Mr. Santos is recalled.

## LAWRENCE SANTOS

was recalled as a witness for and on behalf of the petitioner and, having been previously duly sworn was examined and testified further as follows:

(Testimony of Lawrence Santos.)

Recross Examination

Q. (By Mr. Tonjes): Mr. Santos, I show you a copy of a letter dated April 23, 1952, addressed to Mr. Lawrence Santos, 1051 Fourth Street, Honolulu, and signed by J. M. Alsup, and bearing a notation of approval by Lawrence Santos, and ask you if you have seen the original of that document?

A. It has my signature to it.

Q. I will ask you, Mr. Santos, if that letter contains the agreements which were reached pursuant to the many conferences which were had between, we will say between January 1, 1952 and the date of this letter? [117]

A. To a certain extent, yes, not the whole way.

Q. Not all the way? A. No.

Q. Why did you sign it if it didn't go all the way? A. Why did I sign it?

Q. Yes.

A. So that I could keep the store going.

Q. What was agreed to that is not in here?

A. The adjustments that came through later.

Q. No, you misunderstand me. What agreements were made between you and Government counsel, which are not contained in this writing, which you approved?

A. I would have to read it again.

Q. Take your time, and study it thoroughly.

A. What is your question?

Q. As I understand it, you just stated that this letter did not contain all of the agreements which were entered into as a result of numerous confer-



(Testimony of Lawrence Santos.)

ences had between January 1, 1952, and the date of that letter.

A. That is right, and a lot of these things were never done.

Q. Never mind whether they were done, or not. Did you agree to anything else?

A. Did I agree to do anything else, except what is written in here? [118]

Q. Did you and the Government reach any other agreements, in addition to those that are embodied in that letter?

A. Yes, we reached an agreement about my wife's taxes, and that is not embodied in here.

Q. Who did you reach that agreement with?

A. With yourself, and with Mr. Robinson and with Mr. Alsup.

Q. Why did you sign this when you tell me it is incomplete?      A. Why did I sign that?

Q. Yes.

A. Because this had more to do with my interrogation than anything else. That is what that was about.

Q. This had nothing to do with any interrogation——

A. That is dated as of March 27, and that is the date I was being interrogated.

Q. This is dated April 23.

A. With reference to March 27.

Q. And is this not the result of all of the several conferences that we had?

A. This is the result of what it says over there,

(Testimony of Lawrence Santos.)

Mr. Tonjes. Let me look at it once more. "Reference is made to our conference of March 27, 1952."

Q. That was the last one before that date, wasn't it— [119] the last lengthy conference any way?

A. I wouldn't say that. I would say we must have had some other conferences after that.

Q. Do you have any other agreements in writing which provide for any other matters which are not embodied in this letter?

A. Previous to that?

Q. Any time at all.

A. We had two or three agreements with the Government, they were eliminated.

Q. (By The Court): Were they in writing? That is the question.

A. They were in writing, yes.

Q. (By Mr. Tonjes): They are in writing?

A. Yes, that is right.

Q. Where are copies of them?

A. Most of the copies—the copies I would sign were turned back to you folks. Just like the interrogations—we had more than one interrogation of me and we don't produce any more interrogations. You interrogated me more than once.

Q. Yes.

A. Where are the copies? I swore to them.

Q. I don't know. Why didn't you ask for them if you [120] wanted them. I don't give them out. My point is this, Mr. Santos, that I naturally assumed that when people sit down across the table

(Testimony of Lawrence Santos.)

and negotiate they put everything they want to agree to in writing; isn't that correct?

Mr. Goodsill: I object to that line of argument, your Honor.

The Court: Well, it is cross examination. Let's let him finish with the questions.

Q. (By Mr. Tonjes): Or is it?

A. Sometimes you don't get it in writing.

Q. I want to ask you, Mr. Santos, whether we didn't have several conversations and didn't we have several instruments in writing?

A. Instruments in regard to the sale of the store, and everything that you wanted to sign were the instruments that I would sign.

Q. That's right. A. Yes, sir.

Q. And anything you wanted in there you got in there, didn't you? A. Not always, no.

Q. No, not always. We had our rights to protect, and we protected them, and you agreed to that.

A. It was all to do with the March 27th conference, [121] and that is all that you asked me.

Q. Do you have anything else in writing, in addition to this document? A. Do I have any?

Q. Yes. A. No, I don't.

Mr. Tonjes: The Respondent offers in evidence the letter identified by Lawrence Santos.

The Court: The witness has identified it as a correct copy of the original, has he not?

Mr. Tonjes: With his signature on it, yes, your Honor.

The Court: Is there any objection to it?

(Testimony of Lawrence Santos.)

Mr. Goodsill: No, your Honor.

The Court: There being no objection, the Respondent's Exhibit R is received in evidence.

(Respondent's Exhibit R was thereupon received in evidence.)

Q. (By Mr. Tonjes): Did you show that letter to your lawyer? A. No, I did not.

Q. You say you did not show it to your counsel?

A. That is correct. In fact, I don't even have a copy of it.

Q. You don't have a copy of that letter? [122]

A. That is correct.

Q. What did you do with the copy you got?

A. I don't think I got a copy.

Q. Yes, you got a copy.

A. It is my recollection that I didn't.

Mr. Goodsill: He says he had not got a copy.

Mr. Tonjes: I say he got one, so that is all right, too.

Mr. Goodsill: Yes, Mr. Tonjes, but that is not evidence.

Mr. Tonjes: Your Honor please, at this time the Respondent moves to strike all of the testimony concerning these various meetings and agreements, whereby the petitioner contends that this matter of asserting the transferee liability may not be further pursued by the Government on the grounds of estoppel.

The Court: Well, at this time, the motion will be denied. You can cover it in your briefs, and I

will take care of it when I write up the case. The motion is denied.

Mr. Tonjes: That is all.

(Witness excused.)

The Court: Does the petitioner rest?

Mr. Goodsill: The petitioner rests.

The Court: Does the Government rest? [123]

Mr. Tonjes: The Government rests.

The Court: Gentlemen, how much time do you think you will need for filing your briefs?

Mr. Goodsill: After we get the record, I should think forty-five days will be ample.

The Court: It will be some little time before you get the transcript.

How about sixty days for the filing of your original brief? Do you desire to file simultaneous or concurrent briefs?

Mr. Maiden: I presume, perhaps, inasmuch as we have the burden of proof, perhaps we should file the opening brief, and Mr. Goodsill file a reply brief. I believe that would perhaps be best. I should like sixty days, if the Court please.

The Court: Very well, the Respondent will be given sixty days in which to file his original brief, and the petitioner will be given forty-five days thereafter for the filing of reply brief, or answering brief.

How much time for your reply brief?

Mr. Maiden: Thirty days. Mr. Goodsill and I will exchange briefs as we send them in.

Mr. Goodsill: Yes.

The Court: Now, let's get the exact dates. That



[124] will be sixty—sixty, forty-five and thirty days, Mr. Clerk.

The Clerk: The Respondent will file his opening brief on September 23, the petitioner's reply brief on November 8, the Respondent's reply brief on December 8, 1954.

The Court: If there is nothing further in connection with this case, that concludes the hearings so far on this calendar, and we will be adjourned.

(Thereupon, at 3:15 o'clock p.m., the hearing in the above-entitled petition was closed.)

[Endorsed]: T. C. U. S. Filed Aug. 30, 1954.

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## PETITIONER'S EXHIBIT No. 2

### STATEMENT OF MR. LAWRENCE SANTOS

1051 Fort Street, Honolulu, T. H., taken in the office of the Collector of Internal Revenue, Honolulu, T. H., at 9:50 A.M., March 27, 1952.

Present were: Mr. J. M. Alsup, Collector; Mr. Henry Robinson, Assistant Collector; Mr. E. A. Tonjes, Special Assistant to the Chief Counsel; Mr. Calvin J. H. Chun, Chief Field Deputy; Mr. Howard A. Patterson, Deputy Collector, and Mr. Lawrence Santos, Mr. Milton Cades.

Recording Secretary: Alma T. Chung.

Mr. Patterson: Will you please stand and raise your right hand? Do you, Lawrence Santos, solemnly swear that the statements to be made at this time with respect to your present financial condition

Petitioner's Exhibit No. 2—(Continued)

are true and correct and that you have no assets, either directly or indirectly owned, of any nature other than those now being revealed?

Mr. Santos: I do.

Mr. Tonjes: (To Mr. Chun) What are the years involved in this?

Mr. Patterson: '43, '44, '45—

Mr. Tonjes: '43 is the earliest year. What's the latest year?

Mr. Patterson: '47.

Questions by Mr. Tonjes:

Q. As I understand it, you are in the shoe business and you are a stockholder in the Manufacturer Shoe Company. Is that right? A. That's right.

Q. Do you know how many shares of stock you own in that organization? A. 15,750 shares.

Q. They are in your name? A. Yes.

Q. Does any other person hold any stock in the Manufacturer Shoe Company for your benefit?

A. No—you mean do I have any other stock in anybody else's name—no.

Q. Did you ever give away any stock of the Manufacturer Shoe Company?

A. Well, my children. If that's what you mean. I gave my children stocks in the Manufacturer Shoe Company.

Q. Did you transfer or dispose of any stock to some other person, in the open market or elsewhere? Did you receive less than a full or adequate consideration for it?

A. To the best of my knowledge I haven't.

## Petitioner's Exhibit No. 2—(Continued)

Q. Did you give any other person any stock for which you did not receive full or adequate consideration?

A. Other than my children, no. I gave them money and they bought stocks.

Mr. Cades: They didn't buy the stocks.

A. No, they didn't buy the stocks. The Trust bought the stocks. The Company was a partnership. The Trust got its share.

Q. When was the Manufacturer Shoe Company organized?

A. To the best of my knowledge, 1947. You are talking about the corporation? Yes, 1947. Prior to that time I had been in a partnership.

Q. Who were the partners?

A. My son and daughter. Hawaiian Trust Company as trustee.

Q. When was the partnership organized?

A. To the best of my knowledge it was in '45.

Q. In 1945? A. Yes.

Q. You were a member of the partnership when it was first formed? A. Yes.

Q. Who else was in the partnership?

A. Hawaiian Trust Company as trustee for June and Bruce Santos, and Lawrence Santos.

Q. When did you first go into business?

A. I went into the business in 1942.

Q. You organized the business?

Mr. Alsup: Lawrence bought the business out, I think.

A. Yes, that's right, Jim. I operated then as

Petitioner's Exhibit No. 2—(Continued)

Lawrence Santos, doing business as Manufacturer Shoe Store.

Q. You were the sole proprietor of that business?

A. In 1942? Yes.

Q. That's down on Fort Street?

A. Yes, that's right.

Q. That's the business now carried on by the company? A. Yes.

Q. What was the first change that took place in that business?

A. I am not positive, but to the best of my knowledge, it was in 1945.

Q. What happened then? In other words, you were still the sole proprietor in 1945?

A. Part of 1945.

Q. Sole proprietor? A. Yes.

Q. All right. What happened in 1945?

A. I formed a partnership then. Hawaiian Trust Company as trustee for June and Bruce Santos, and myself.

Q. No other partners? A. No.

Q. What were the respective partnership interests? In other words, how much did you own and how much did the children own?

A. I own 60% and the children own 40%.

Q. Do you know where the Hawaiian Trust Company got the money to put into the business?

A. Yes.

Q. Where did it come from?

A. I made a gift to the children. I don't know how to put it.

Petitioner's Exhibit No. 2—(Continued)

Mr. Chun: How much did you pay?

A. I don't know. I paid a certain amount of money to the Hawaiian Trust Company. They have it in the record. I don't know how much it was. It was 40%.

Q. There was no consideration for that transfer?

A. There was a consideration.

Q. What was the consideration? How much did you give the children? You don't recall what the amount was?

A. Either sixty or seventy thousand.

Q. Seventy thousand, you say? Where did you get that money?

A. Where did I get it? From the money I made from the business.

Q. Profits from the Manufacturer Shoe Company? A. Yes.

Q. Did you have any other business interests about that time? A. No.

Q. Sixty thousand dollars—did you have any money left? A. Yes.

Q. How much? A. I don't know.

Q. Can you find out?

A. I don't know. I can try.

Q. Don't you have any records?

A. I have no records as an individual.

Q. You mean you don't know how much you made and how much you had left over?

A. No.

Q. The law requires you to do it. You made a gift of approximately seventy thousand dollars to



Petitioner's Exhibit No. 2—(Continued)

your children and the gift was in the form of a transfer of funds to the Hawaiian Trust Company as trustee for the children? A. Yes.

Q. Then the Hawaiian Trust Company did what with that money? Did they buy stock in the Manufacturer Shoe Company?

A. Yes, they bought stock to organize the partnership at about that time. The corporation was not organized until later. Then the business operated as a partnership for a while.

Q. Do you know how much you made as a partner? A. No, but I can find out.

Q. How long were you in the partnership?

A. Until 1947.

Q. What happened in '47?

A. Then we incorporated.

Q. How much did you get in shares or percentage?

A. I got fifteen thousand—no—I got fifteen thousand—I believe I got 15,750 shares. The children got the balance.

Q. How much was that?

A. They got 40%. Let's see—40% of 35—they got 14,000 shares.

Q. That's for the two children together?

A. Yes.

Q. Did your wife get any stock?

A. Yes, she got 5,250 shares.

Q. What did she pay for that?

A. It was part of her income from the community property.

Petitioner's Exhibit No. 2—(Continued)

Q. Did she pay anything for it?

A. \$52,500.

Q. I don't follow that. She was issued stock. Is that right? How did she get an interest in the partnership? You first started the business as an individual, then you carried it as a partnership with your two children with the Hawaiian Trust Company as trustee. Is that correct?

A. That's right.

Q. Later the corporation was organized and stock was issued. Why did your wife get it?

A. From the money she got from the community property. From the money for her share of the community property.

Mr. Cades: Would you like me to explain? At that time Cameron & Johnston determined Mrs. Santos' interest in the Manufacturer Shoe Company. Community property came into being on June 1, 1945. The transfer of these assets had to be made legally. A measurement was made by Cameron and Johnston. A division of the property took place at that time and the value of her interest was the number of shares she got, referring to her interest in the old partnership. Is that correct?

Mr. Santos: Yes.

Q. Cameron and Johnston figured out the distribution of that interest?

Mr. Cades: Under Hawaiian law does the income earned by the husband become community property?

Mr. Chun: Yes, it does.

## Petitioner's Exhibit No. 2—(Continued)

Mr. Tonjes: How about income earned from separate property?

Mr. Cades: In that respect, Hawaii is like Texas, not like California. It is community property, whether it's from separate income, or spendthrift trust.

Mr. Tonjes: Well, going back to the item we were discussing—do you own any other stocks in any other corporation in your name or anyone else's name?

A. Is that the list I turned over to Mr. Alsup?

Mr. Patterson: Yes. That's your receipt.

Mr. Tonjes: Do you own other stocks in other corporations?

A. Yes, I have 25 shares in Pacific Gas.

Q. What other stocks do you own, besides the one you mentioned in the Manufacturer Shoe Store?

A. Williams Mortuary.

Q. How many shares? A. Thirteen shares.

Q. What other stocks do you own?

A. 200 shares of Pacific Refinery—no that's supposed to be—oh, yes, here it is—400 shares of Pacific Refinery; 1 share Consolidated Amusement; 13 shares of Williams Mortuary; 100 shares of Honolulu Gas; 250 shares of Pacific Gas and Electric. I believe that's about all.

Q. That's all the stock you now own? Are they in your name? A. Yes.

Mr. Cades: Some of them are in the name of Schwartz, aren't they?

A. Oh, yes, some are in the name of Schwartz.

## Petitioner's Exhibit No. 2—(Continued)

Q. Do you have any bonds or other evidence of indebtedness?      A. Of indebtedness?

Q. Yes, does anyone owe you any money? You understand the difference between stocks and bonds? Do you own any government bonds?

A. Yes, my wife's bonds.

Q. Your wife's? Did you give them to your wife?

A. I don't know how to answer that question.

Q. What is the name of these bonds?

A. Government bonds.

Q. How much are they worth? What is the face value of it?

A. About seventy thousand dollars.

Q. Where are they now?

A. My wife has them, and she is selling them.

Q. How did you wife get them? Why did you give them to her?

A. It was sort of a distribution between the two of us.

Q. Are those all the bonds that you had?

A. I had more, but I sold them.

Q. You gave your wife about seventy thousand dollars worth? When did you deliver them to her?

A. That I can't answer.

Q. Was it this year?

A. No, before this year.

Q. Was it last year?

A. Over a period of time. Not this year. Nothing this year.

Q. Then it was several times that you gave her

Petitioner's Exhibit No. 2—(Continued)

those bonds. Do you have any record of how much you gave her?

A. I believe it was seventy thousand dollars.

Q. You say you gave it to her all at once. Could you say approximately when you gave her these bonds? A. No, I honestly couldn't.

Q. Do you know when the first transfer was made to her?

A. Quite a few years. I don't know how many years.

Q. When did you first start buying government bonds?

A. I could check that and give you an accurate answer.

Q. If you care to do that we would appreciate it. Did you give any bonds to any other person?

A. No.

Q. To hold for your benefit? A. No.

Q. Do you have any other person now holding any stock for your benefit? A. No.

Q. Did you either give or have transferred to any other person any stocks which were to be held for your benefit?

A. I didn't give any stock to anybody.

Q. You never gave any stock to anybody?

A. No.

Q. Except for full consideration? A. Yes.

Q. Do you know a person named Rose Sills?

A. Yes, very well.

Q. Is she an employee of the Manufacturer Shoe Company? A. Yes.



## Petitioner's Exhibit No. 2—(Continued)

Q. Did you ever give her any money or stock to be held by her for you?      A. No.

Q. At no time? I mean 1943 to the present time.

A. Yes, for a while I had an account under the name of Rose Sills but the stocks and bonds that she had were sold. It wasn't her account—it was mine. No stocks or bonds belonged to her. They belonged to me.

Q. Do you have any brokerage accounts now under your own name?

A. You mean do I have something in there? No. I haven't any account at all. I haven't gone near a brokerage house for a year, if that's what you mean.

Q. How many bank accounts do you have?

A. I don't have any bank accounts.

Q. No bank accounts at all? Both in Honolulu and on the mainland?

A. I take that back. I had an account at the Wells Fargo Bank. In San Francisco. I still have an open account. There's some forty odd dollars there.

Q. You have any other accounts?      A. No.

Q. Do you have any other business interests? In any company?      A. No.

Q. Power Company?

A. No, not even in Mexico City. I mention Mexico City because I was accused of having money down in Mexico City.

Q. Do you have any persons owing you any money on open account?      A. Yes.

Petitioner's Exhibit No. 2—(Continued)

Q. How much? Are they over \$500?

A. No.

Q. No person owes you any more than \$500?

A. That's correct.

Questions by Mr. Chun:

Q. Does the Manufacturer Shoe Company owe you anything outside of the shares of stock and accrued salary?

A. No, they don't. I owe the Manufacturer Shoe Company.

Q. Is the corporation holding anything for you, either in the safe or vault? A. No.

Q. How much do you owe the corporation?

A. \$105 or \$110.

Q. How was that incurred?

A. Mostly on payments from year to year in taxes.

Q. When was the first time it was incurred to the corporation?

A. You'll find it on the back of the note. I gave you a copy of the note. Remember, Henry, I gave you a copy of the note.

Mr. Robinson: I don't recall.

A. It was attached to the stock certificates.

Mr. Robinson: Oh, I didn't notice. They're in the Cashier's vault.

Questions by Mr. Tonjes:

Q. Do you have any safety deposit boxes at all?

A. Yes.

Q. Where is it?

A. Hawaiian Trust Company.

## Petitioner's Exhibit No. 2—(Continued)

Q. Do you have any other box besides that?

A. No.

Q. Anyone renting a box in his name for you?

A. No.

Q. You don't have access to anyone else's box?

A. That's right.

Q. Do you have an automobile? A. No.

Q. Don't you own an automobile?

A. The corporation owns that.

Q. Real estate?

A. No, I don't. I don't know how to explain that.

Q. Leasehold, you mean?

A. Yes, I rent from Lowell Dillingham.

Q. You rent a house? A. That's right.

Q. Furnished or unfurnished?

A. Unfurnished—no, I mean furnished.

Q. How much is your furniture worth?

A. Couple of thousand.

Q. Four thousand?

A. I would say about three thousand. I haven't bought anything in years.

Q. Do you own any diamonds or jewelry?

A. I have a diamond ring.

Q. How much is it worth?

A. Paid around \$450 for it.

Q. No other jewelry of substantial value?

A. I got a watch.

Q. Nothing over \$500? A. No.

Q. Do you own any leaseholds?

A. No. I had one but I don't have it anymore.

## Petitioner's Exhibit No. 2—(Continued)

Q. Have you any life insurance? A. No.

Q. No life insurance?

A. That is correct. I have no life insurance policy—not payable to me.

Q. Are they contract premium or life that you know? How many and what is the face value?

A. This is just what I am guessing at. \$225,000 for two term life insurances with Prudential.

Q. Who is the beneficiary?

A. I think it's my children. I can check that.

Q. Who pays the premium on that?

A. The children—no, it's my wife.

Q. Where does she get that money?

A. From her income.

Q. Where does she get her income from?

A. From this community property.

Q. What source of income has she today?

A. She has dividends in the Manufacturers Shoe Company. And the household money. Women usually pinch that.

Q. Are those the only life insurance policies you have?

A. I have U. S. Life. \$44,000—I am not sure.

Mr. Chun: What else is there?

A. I have to check. They are not in my possession. They are in hers.

Mr. Chun: What about Von Hamn Young?

A. Oh, yes, I have one with Manufacturer's Life.

Mr. Tonjes: Do you have anything else of any character being held for you for your benefit?

A. What do you mean by character?

## Petitioner's Exhibit No. 2—(Continued)

Q. Anything of value. A. No.

Q. Nothing of value?

A. There's my mother's estate. I am sole beneficiary. I have interests in my mother's estate.

Q. In addition to that, do you have anything else of value, Mr. Santos? Do you have anything in someone else's name that might be of some value?

A. I don't have anything else. I don't have anything else in any other company.

Q. Do you have anything else on the face of the earth?

A. I don't know how to answer that question right now.

Q. Do you understand the question? What part don't you understand? Tell us and we can discuss it.

A. I want to give you an answer, but I want to give you a correct answer on that. That's why I am holding up from answering it.

Q. I just want you to appreciate the significance of the case. The whole topic of our discussion has been leading up to that.

Mr. Chun: No property?

A. No property. Well, I'll explain it then. Then you can discuss it. I have an agreement with Lou Haiman in which I have advanced to him money and I am supposed to get a share in Lou Haiman, Incorporated. The amount of the money invested in there is \$40,000. I don't know what you call it—stock, investment, an agreement or money or what the thing is.



Petitioner's Exhibit No. 2—(Continued)

Q. Who is Mr. Haiman?

A. De Liso Deb man.

Q. How do you spell his name?

A. H-a-i-m-a-n.

Q. And Lou?

A. Louis, I guess. I guess Lou is for Louis. I call him Lou. I want to get this agreement and turn it over to you.

Q. When was the money advanced?

A. Not better than a year ago.

Q. What is his address?

A. I don't know. I'll get it for you. It's in St. Louis, Missouri. I will get the agreement and turn it over to you. If it's stock, I will turn it over to you. He lives in Los Angeles. The stock will be turned over to you.

Q. Do you have any other property or property rights?

A. To the best of my knowledge, no.

Q. Does the partnership still owe you anything?

A. No.

Q. Hold anything for you? A. No.

Q. Does the partnership have any assets now? As a partnership?

A. No. The assets go ahead into the corporation.

Q. You had some real estate at Halelea Place?

A. I sold that property through Howdy Reynolds. They sold it to somebody.

Q. I understand it is now owned by William T. and Ethel S. Bolger. Are they related to you?

Petitioner's Exhibit No. 2—(Continued)

A. To me? I don't think so.

Q. Is William T. Bolger related to you?

A. No.

Q. Is Ethel S. Bolger related to you?

A. I don't know either one of the two. We are not related. I don't even know who they are.

Q. How much did you get for the place?

A. I got \$20,000 net or \$20,000 gross.

Q. Have you any mortgages receivable now?

A. Just that agreement we were talking about.

Q. Did you lend any money out? A. No.

Q. Does the City Finance and Mortgage Company owe you anything?

A. No. To the best of my knowledge they don't owe me a dime.

Q. There was a transfer of your old Diamond Head home to the corporation. Was there any consideration for that transfer?

A. I didn't own any property in Diamond Head. The corporation did.

Q. Was it in your name?

A. I don't believe it ever was. It was paid for by the corporation. When it was sold the money went into the corporation. Does that answer it? I got no money out of it.

Q. Did you put any money into that home?

A. Did I?

Q. Yes. A. No.

Q. It was purchased with corporation funds?

A. I believe it was purchased with partnership funds. It went as an asset to the corporation.

Petitioner's Exhibit No. 2—(Continued)

Same as I did when I bought the Manoa property.

Q. How about the Cadillac?

A. What about the Cadillac?

Q. Did you first buy that yourself?

A. The Cadillac is now in the corporation name. Anything in the name of the corporation was bought by the corporation.

Q. Was it ever in your name?

A. To the best of my knowledge it never was. Check it through the registration.

Q. I believe the records show the Cadillac was in your name and transferred to the corporation.

A. I will have it verified. I don't think it's correct.

Q. It shows that it was transferred from you to the corporation.

A. It was bought directly from Schuman's for \$3,000 then it was turned over to the corporation. That could be possible—that I don't know. As far as I know, it was in the corporation's name. I don't know. It's a corporation thing.

Q. Did you at any time have any assets in Sacramento, California?

A. This fellow lives in Sacramento. He lives with neighbors around that retail shoe store.

Q. Did you have any assets in Sacramento?

A. It is that agreement in Sacramento.

Q. Outside of whatever Haiman owes you, do you now have anything in Sacramento?

A. I haven't anything—nothing.

Q. How many stores does Haiman own?

## Petitioner's Exhibit No. 2—(Continued)

A. One.

Q. Outside of that consideration, did you ever have any interest in Bon Marche?

A. That's the one we are talking about. We don't have any interest in Bon Marche. That's a big store. Haiman deals with Bon Marche.

Questions by Mr. Robinson:

Q. What assets do you have in the safety deposit box in the Hawaiian Trust Company?

A. Didn't you search that? I made you go up there.

Q. No, we didn't go. Will you stand the expense of opening the box?      A. No, sir.

Q. You offered to pay for the expense.

A. Yes, sure, I'll pay it.

Question by Mr. Tonjes:

Q. One more thing I wanted to ask. Have you kept your determination of profit and loss for the past year in the store? Have you a profit and loss statement?

A. No. February 28 is the end of the year for us. They haven't finished working on it yet.

Q. Could you send us a copy of your profit and loss statement when it is completed?

A. Sure, I'll do that for you.

Mr. Alsup: You still want his financial statement?

Mr. Tonjes: I think this takes the place of it. It might be to your advantage, though, to submit a statement to us. There might be some future occasion when we might want it.

Petitioner's Exhibit No. 2—(Continued)

Mr. Alsup: Let's get down to a point. Make a deal with him. How much out of this you got at the present time?

Mr. Chun: How much he got? In shares you mean? 15,750 shares.

Mr. Alsup: No, no—how much money?

Mr. Chun: \$157,500 par value in Manufacturers Shoe Store.

Mr. Alsup: What other stocks has he got?

Mr. Chun: Pacific Gas—\$12,500.

Mr. Alsup: Then we're going to get how much out of this fifty or sixty thousand he is getting?

Mr. Santos: Around \$65,000. Then there's all the stocks from my mother's estate. That comes to around \$60,000.

Mr. Alsup: Now, let's see, that comes to around \$295,000. Now, Lawrence, what you make over your salary in the store you will turn over to us?

Mr. Santos: Yes, sir, and also the bonus and 25% of the profit will be bonus. That will be turned over to you.

Mr. Alsup: Let's bring this thing to a close one way or another. You know what you got and what Manufacturer Shoe Store got. Let him draw up an agreement.

Mr. Santos: I want you folks to draw it up.

Mr. Tonjes: I don't think an agreement is necessary if he meets the payments as indicated—the \$70,000 from his wife and his other funds.

Mr. Chun: Well, the \$150,000 will liquidate his



Petitioner's Exhibit No. 2—(Continued)  
wife's account. We could dispose of some of his stocks other than Manufacturers Shoe Store.

Mr. Alsup: Your whole idea is to stay in business, isn't it?

Mr. Santos: Yes, but I'd like to keep my interest in this Lou Haiman deal.

Mr. Chun: Is there any income coming out of that?

Mr. Santos: No, it's just an agreement.

Mr. Alsup: Are you gentlemen agreeable? Mr. Robinson?

Mr. Robinson: What assurance do we have that you will have the \$150,000?

Mr. Cades: The check in payment of the bonds is going to come direct to me. I will immediately transmit it to you. (To Mr. Santos.) The \$60,000 of the estate you will immediately write to your attorney and find out what has to be done. I don't see any point in making any further agreements. The agreement which he made outlines our position.

Mr. Santos: Can't I get something in writing?

Mr. Tonjes: We could acknowledge receipt of the stocks.

Mr. Cades: Say that he has made arrangements for the turning over to you what property, including the Manufacturer Shoe stock property, he has, and that the stock will not be sold as long as he continues to comply with the arrangements set forth.

Mr. Alsup: Just say we have made satisfactory

Petitioner's Exhibit No. 2—(Continued)

arrangements with him to take care of his back taxes.

Mr. Santos: That's what I mean. In other words, we have made arrangements for the payment of my tax.

Mr. Tonjes: I wouldn't say that, Mr. Santos. We don't know how much your tax is. We have reached a position where I think we might be justified in not selling the stock.

Mr. Santos: Don't say might—please.

Mr. Cades: Assuming that everything is correct—then the understanding is that you will not sell the stock and he will be allowed to run the store with all payments above the salary to be paid to you?

Mr. Tonjes: That's about the size of it. There's one thing I might add—if this estate in California drags on without a complete settlement over what might be a reasonable time, we would have a legal squawk coming.

Mr. Santos: Yes, then the procedure would be legal.

Mr. Cades: (To Mr. Santos) Can you write to your attorney? We want to get the estate settled. If he does require your staying in California for an extended period, does he recommend your resignation and have some other executor.

Mr. Alsup: Henry, are you satisfied with this agreement?

Mr. Robinson: Will he give us his financial statement?

## Petitioner's Exhibit No. 2—(Continued)

Mr. Alsup: I mean are you satisfied with this?

Mr. Robinson: Yes.

Mr. Alsup: Mr. Chun?

Mr. Chun: Are you going to give us a copy of this agreement with Mr. Haiman? Are you going to have that liquidated?

Mr. Santos: If possible, I'd like to keep that stock going. That's the only two stocks I'd like to keep—Lou Haiman and Manufacturer Shoe Store.

Mr. Alsup: He's going to turn it over to us and let us look it over.

Mr. Santos: Lou is a representative of the De Liso Deb line. We do a lot of business with them. McInerney is the only other store handling the De Liso Deb line and we are about to get it along with them.

Mr. Chun: Would Lou Haiman buy the stock back?

Mr. Santos: He probably would, but he wouldn't pay \$40,000 for it. He would only buy it for about \$10,000.

Mr. Cades: You can't get \$40,000 for it.

Mr. Alsup: I just want to close this thing up. We should reach an agreement so we can quit running after him.

Mr. Chun: Try to get the store to buy that.

Mr. Santos: That's up to you folks.

Mr. Chun: We can go ahead now and sell it.

Mr. Santos: If you want to sell it, it will just kill the thing.

Mr. Tonjes: We have to see what happens.

## Petitioner's Exhibit No. 2—(Continued)

Mr. Santos: Someday that thing will pay for itself. You have to take a loss if you sell it now.

Mr. Chun: Try to get him to buy it back. Or get the store to buy it. The store would be more interested than you are.

Mr. Cades: You got no objections to selling it back to him?

Mr. Santos: All he has in there is \$10,000. He has the controlling interest. All they can get is dividends. That \$40,000 is going well.

Mr. Chun: Can't you work on the directors to buy that?

Mr. Santos: I can try, but if you know Mr. White—how much you want? I don't think you'll get very much.

Mr. Alsup: Are you satisfied to go along with this deal?

Mr. Tonjes: I don't think we want to commit ourselves.

Mr. Santos: When we are through with this tax court we will come back and discuss what's going to happen to the store. We can check back here and make a new deal. Allow me to run the store with the condition that I be able to run it as a proper manager.

Mr. Alsup: Are you satisfied with this, Henry?

Mr. Robinson: Yes.

Mr. Alsup: Mr. Chun?

Mr. Chun: Can the store give us copies of whatever statements you make? Do you make them

Petitioner's Exhibit No. 2—(Continued)  
monthly, quarterly, or yearly? That's what we want.

Mr. Santos: How do you want them made? We'll make them the way you want them.

Mr. Chun: Just give us copies whenever you make them.

Mr. Santos: All right. If I don't live up to my part of the agreement you can take whatever action is necessary.

Mr. Robinson: In the event Mrs. Santos' taxes are paid in full and you can file claim for refund, will she be willing to turn it over to us?

Mr. Cades: I understand she will not.

Mr. Santos: I tried to work that.

Mr. Cades: I understand that this business of dividing community property is something she insisted on.

Mr. Alsup: She has that right.

Mr. Cades: She has that right according to law. She got hers out of that. She was not going to let it go.

Mr. Alsup: Henry, are you satisfied?

Mr. Robinson: Yes.

Mr. Alsup: Mr. Chun?

Mr. Chun: Could we have a limitation to that agreement. Make it about three or four months. Or make it run no more than four years.

Mr. Santos: You can do that if you want to. All right, make it.

Mr. Robinson: The limitation is 6 years on collections.



Petitioner's Exhibit No. 2—(Continued)

Mr. Santos: This is just the beginning, isn't it?

Mr. Patterson: That salary that you are going to draw. Is that for ordinary living expenses?

Mr. Santos: Yes. \$2,000 and no more.

Mr. Tonjes: We have a general understanding of what we want to do and that understanding is that he is to draw a salary of \$2,000.

Mr. Patterson: That \$2,000 will include your living expenses and current taxes. Anything over that will be turned over to us?

Mr. Santos: Yes.

Mr. Alsup: Mr. Tonjes, as legal advisor, are you satisfied?

Mr. Chun: On that \$2,000—you are not going to draw anything more than \$2,000 out of the corporation?

Mr. Cades: He will live on \$2,000 a month less the withholding.

Mr. Chun: How about that 25% bonus. Can't you eliminate that?

Mr. Tonjes: Do you have to pay yourself that bonus?

Mr. Santos: According to this Wage Stabilization thing.

Mr. Tonjes: Maybe it would be better to leave that money in the corporation.

Mr. Cades: If he suspends that thing, he can't ever get it back again.

Mr. Santos: It would come out of the corporation anyway.

Mr. Cades: It wouldn't increase the corpora-

Petitioner's Exhibit No. 2—(Continued)  
tion's worth because they have to pay the tax any-  
way. He is entitled to that bonus.

Statement completed at 11:50 a.m.

I have carefully read the foregoing transcript of  
my statement, pages 1 to 27, and I hereby certify  
that, to the best of my knowledge and belief, it is  
a true and correct transcript of my answers to the  
questions therein propounded.

.....  
Lawrence Santos

Admitted in Evidence July 23, 1954.

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[Endorsed]: No. 15371. United States Court of  
Appeals for the Ninth Circuit. Irmgard Santos,  
Petitioner, vs. Commissioner of Internal Revenue,  
Respondent. Transcript of the Record. Petition to  
Review a Decision of The Tax Court of the United  
States.

Filed: November 19, 1956.

Docketed: November 28, 1956.

/s/ PAUL P. O'BRIEN

Clerk of the United States Court of Appeals for  
the Ninth Circuit.

In The United States Court of Appeals  
for the Ninth Circuit

No. 15371

Tax Court Docket No. 46327

IRMGARD SANTOS,

Petitioner on Review,

v.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent on Review.

STATEMENT OF POINTS

The points on which petitioner intends to rely on this appeal from the opinion and final order and decision entered by the Tax Court of the United States are:

1. The Tax Court erred in determining that petitioner Irmgard Santos was a transferee of the assets of Lawrence Santos in the amount of \$68,287.90.

2. The Tax Court erred in determining that petitioner is liable as transferee of the assets of Lawrence Santos in the amount of \$68,287.90 because there was no transfer of assets of Lawrence Santos to petitioner.

3. The Tax Court erred in failing to hold that the assets and money involved were the separate property of the petitioner and were used by petitioner to pay her separate Federal income taxes.

4. The Tax Court erred in holding that petitioner, Irmgard Santos, received a gratuitous transfer of property of the transferor, Lawrence Santos, while insolvent, of the value of \$68,287.90, and is liable as transferee to that extent.

5. The Tax Court erred in determining that the respondent had met the burden of proof to show transferee liability.

6. The Tax Court erred in determining petitioner was liable as a transferee when she merely received her share of community funds and used those funds to pay her own taxes on her share of community income.

7. The Tax Court erred in failing to hold that the respondent on review is estopped from proceeding against petitioner as transferee because of respondent's agreement to apply the proceeds of the assets alleged to have been transferred solely against petitioner's individual income tax liability.

8. The Tax Court's opinion and decision are not supported by the evidence.

9. The Tax Court's opinion and decision are contrary to law.

November 29, 1956.

Respectfully submitted,

/s/ ROBERT ASH

Attorney for Petitioner on Review.

Service of Copy Acknowledged.

[Endorsed]: Filed Nov. 30, 1956. Paul P. O'Brien, Clerk.

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IN THE  
**United States Court of Appeals**

FOR THE NINTH CIRCUIT

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No. 15,371

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IRMGARD SANTOS, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

---

**Petition to Review Decision of the Tax Court of the  
United States**

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**PETITIONER'S BRIEF**

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IN THE  
**United States Court of Appeals**

FOR THE NINTH CIRCUIT

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No. 15,371

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IRMGARD SANTOS, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

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**Petition to Review Decision of the Tax Court of the  
United States**

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**PETITIONER'S BRIEF**

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**JURISDICTIONAL STATEMENT**

**Jurisdiction of the Tax Court**

On October 15, 1952, the Commissioner of Internal Revenue sent to the petitioner, Irmgard Santos, a Notice of Deficiency, in which he determined that the petitioner, Irmgard Santos, as the transferee of assets of Lawrence Santos, her husband, was liable to the extent of \$68,287.90 on account of a deficiency in income tax for the years 1942

to 1946, inclusive, of the said Lawrence Santos. (R. 3) Thereafter, on January 8, 1953, the petitioner duly filed an appeal from said determination with the Tax Court of the United States in accordance with § 272 and § 311 of the Internal Revenue Code of 1939. The case was tried before the Tax Court on July 23, 1954. The Tax Court promulgated its Findings of Fact and Opinion (R. 46) on June 18, 1956, and entered its Decision on the same day, ordering and deciding that the petitioner was liable as a transferee of the assets of Lawrence Santos in the amount of \$68,287.90 on account of income taxes of Lawrence Santos for the taxable years 1943 to 1946, inclusive, together with interest as provided by law. (R. 65, 66)

### **Jurisdiction of the Court of Appeals**

A Petition for Review was filed on September 7, 1956, to review the decision entered by the Tax Court on June 18, 1956. Jurisdiction is conferred upon this Court by Sections 1141 and 1142 of the Internal Revenue Code of 1939 and Sections 7482 and 7483 of the Internal Revenue Code of 1954.

### **QUESTION PRESENTED**

Petitioner and Lawrence Santos were husband and wife during the entire period here involved and both were employed. From the time of their marriage in 1928, they pooled their earnings to purchase jointly-owned homes and to finance Lawrence Santos' business. Under the Community Property Law of Hawaii, which was in effect from June 1, 1945, to June 30, 1949, petitioner's share of the community income thus earned was \$154,976.51 and her tax liability thereon was \$70,289.91. Some time prior to March 27, 1952, the Commissioner of Internal Revenue made a jeopardy assessment and recorded liens against petitioner for the tax on her share of the community income and on her separately reported income for the years 1943 to 1947, inclusive.



Petitioner and her husband quarreled frequently because of her insistence that he pay to her share of the income. Accordingly, Lawrence Santos in 1948, 1949, and 1950 purchased and delivered to the petitioner as a partial payment of petitioner's share of the said income, certain cashiers' checks which were later converted into United States Bonds. \$70,000 of the face value of these bonds were sold in 1952 for \$68,287.90 and the entire proceeds paid to representatives of the Commissioner in full satisfaction of the claims under the jeopardy assessment for income taxes on petitioner's share of the income. The liens on record against petitioner were released when this payment was made.

The Commissioner then asserted a deficiency of \$68,287.90 (the amount paid the Commissioner) against petitioner on the ground that she was a transferee of the assets of Lawrence Santos and made a jeopardy assessment of the said amount. The Tax Court, with two Judges dissenting, affirmed.

The question for decision is:

Is the petitioner liable as a transferee of the assets of Lawrence Santos because she received from him a sum of money representing a portion of her share of the community income and her separately reported income and used that money to pay the tax assessed against her because of earning the said money?

### **STATUTES AND REGULATIONS INVOLVED**

The statutes and regulations involved appear in the Appendix hereto at pages 14, 15.

### **STATEMENT OF THE CASE**

The petitioner and Lawrence Santos were married in 1928. At that time they were both employed, petitioner at Honolulu Gas Company and her husband at Union Trust

Company. They continued to work in their respective jobs after their marriage. (R. 47, 86, 87, 119) Whatever petitioner earned she turned over to Lawrence Santos. Petitioner worked until 1941. (R. 117) In 1932, petitioner and her husband bought their first home in Honolulu out of their joint earnings. Title was taken as joint tenants. (R. 34, 115) Thereafter, they sold their first home and bought another home. Still later they sold the second home and bought a third home. In each instance, title was taken as joint tenants and both petitioner and her husband signed the mortgages. Whatever petitioner earned was turned over to her husband and applied on the mortgages. (R. 116, 117)

In 1937 Lawrence Santos gave up his position and organized Persans, Ltd., to operate a retail shoe store. (R. 34) The \$5,000 invested in Persans, Ltd. was secured by mortgaging the home held as joint tenants. (R. 87) The mortgage was paid from the joint checking account in which both petitioner and her husband's checks were deposited. (R. 118) Petitioner worked for Persans, Ltd. without compensation on Saturdays and on other days after she had completed her regular job. (R. 34, 47)

In 1942 Lawrence Santos purchased Manufacturers' Shoe Store in Honolulu for \$50,000.00. The purchase was financed as follows: Persans, Ltd. borrowed \$50,000 from a bank pledging its assets as security. Persans, Ltd. then loaned the \$50,000 to Lawrence Santos who paid it to the seller of Manufacturers' Shoe Store. Persans, Ltd. was liquidated and the proceeds in liquidation, (\$43,750.35) were paid to Lawrence Santos. (R. 48, 49)

On July 1, 1944, Lawrence Santos created an irrevocable trust by transferring to Hawaiian Trust Company, Limited, the sum of \$70,000.00. The beneficiaries of the trust were the two children of petitioner and Lawrence Santos. The trust then invested the \$70,000 in a 40 percent interest

in a limited partnership formed to carry on the business of Manufacturers' Shoe Store. Lawrence Santos transferred assets of the old Manufacturers' Shoe Store with a book value of \$105,000, to the new partnership for a 60 percent interest therein. (R. 49)

On March 1, 1947, Manufacturers' Shoe Company, Limited, was incorporated to take over the assets and liabilities of the limited partnership. Capitalization was \$350,000, with Lawrence Santos receiving stock with a par value of \$210,000 and the trust \$140,000. (R. 50)

In the early part of 1948, Lawrence Santos requested Cameron and Johnstone, auditors for the corporation and for the limited partnership, to determine what portion of the capital stock of \$210,000 issued to him at the incorporation of Manufacturers' Shoe Company, Limited, represented earnings since June 1, 1945, i. e., the date of the adoption by Hawaii of the Community Property Law. Cameron and Johnstone made an examination and, on April 5, 1948, advised Lawrence Santos that \$105,000 out of the \$210,000 was community property and that his wife would be entitled to receive stock of the par value of \$52,500 in recognition of her community property interest in the earnings of the business from June 1, 1945 to February 28, 1947. On or about April 5, 1948, Lawrence Santos then transferred to petitioner, as of March 1, 1947, capital stock of Manufacturers' Shoe Company of the par value of \$52,500 out of his share of the capital stock of the company, leaving him stock of the par value of \$157,500. (R. 51)

Petitioner's share of the community income of herself and Lawrence Santos for the period from June 1, 1945, (commencement of community property), to February 28, 1947 (the date of the organization of the corporation), was as follows:

June 1, 1945-December 31, 1945	\$ 15,621.92
January 1, 1946-December 31, 1946	54,400.31
January 1, 1947-February 28, 1947	41,564.78

---

Total ..... \$111,587.01

Petitioner's share of the community income of herself and husband for the period from March 1, 1947, to July 1, 1949 (the end of community property), was as follows:

March 1, 1947-December 31, 1947	\$ 11,610.60
January 1, 1948-December 31, 1948	21,063.38
January 1, 1949-June 30, 1949	10,715.52

---

Total ..... \$ 43,389.50

Petitioner's Federal income tax liability on her community income as aforesaid for the taxable years 1945, 1946, 1947, 1948, and 1949 was \$5,240.96, \$28,257.97, \$27,384.49, \$6,165.16 and \$3,241.33, respectively. (R. 50-52)

Petitioner contended that she had an interest in the business of Lawrence Santos because of her contributions to it. Also, she insisted that she should be given her share of the community property. (R. 88, 89, 90, 91, 113, 120, 121, 122, 198) The situation between petitioner and her husband became so strained as a result of her demands that petitioner left Honolulu and went to live on the mainland where she filed a suit for separate maintenance. (R. 51, 92, 134).

Because of petitioner's insistence that she receive her share of the business and community property, Lawrence Santos transferred to her the \$52,500 par value stock in Manufacturers' Shoe Company, Limited. (R. 51)

In addition, Lawrence Santos in 1948, 1949 and 1950 purchased cashiers' checks, payable to Lawrence Santos and/or Irmgard Santos in the aggregate amount of \$82,272.67 and delivered them to petitioner. (R. 52) In November 1950, Lawrence Santos received the cashiers'

checks from petitioner and with them purchased United States Treasury Bearer Bonds in the principal amount of \$80,000. The bonds were delivered to the petitioner. One \$10,000 bond was sold in April, 1952, and the proceeds went to pay the joint Territorial taxes of petitioner and her husband. In March, 1952, petitioner sold the remaining bonds in the principal amount of \$70,000 for \$68,287.90. This \$68,287.90 was paid to the Collector of Internal Revenue in payment of petitioner's individual income tax liability because of her share of community income and her separately reported income for the years 1943 to 1947, inclusive, and the tax liens on account thereof were discharged. (R. 41, 53)

On October 15, 1952, the Commissioner issued a notice of deficiency determining that petitioner owed \$68,287.90 (the amount she had paid the Collector as shown above) as a transferee of the assets of Lawrence Santos. (R. 34) A jeopardy assessment was made of the alleged deficiency of \$68,287.90. Appeal was taken to the Tax Court, which affirmed the action of the Commissioner. (R. 46) Judge Murdock, who is now Chief Judge of the Tax Court, and Judge Johnson dissented. (R. 63)

### **SPECIFICATION OF ERRORS**

The Tax Court of the United States erred:

1. In failing to hold that the money involved was the individual property of petitioner and was used by her to pay her individual income taxes.
2. In holding and deciding that petitioner was a transferee of the assets of Lawrence Santos in the amount of \$68,287.90.
3. In holding that Lawrence Santos while insolvent gratuitously transferred property of a value of \$68,287.90 to petitioner.



4. In determining that the Commissioner had met the burden of proof to show transferee liability.

5. The Tax Court's opinion and decision are not supported by the evidence.

## ARGUMENT

### I. THE PETITIONER, IRMGARD SANTOS, IS NOT A TRANSFEREE OF LAWRENCE SANTOS

The Tax Court opinion is unique in that it does not cite any decisions to support its conclusion. This was probably due to the fact that there are no adjudicated decisions on this exact point.

Stripped of superfluous facts, the question to be decided in this case is simple. Briefly, the facts are that petitioner received certain money from her husband in partial satisfaction of her claim to her portion of their community income and her separately reported income. This money was used by petitioner to pay the income taxes assessed against her on the said income.

The sole question to be decided is:

Is the petitioner liable as the transferee of the assets of her husband because of the receipt and use of the money as indicated?

The decision of the Tax Court should be reversed on the following grounds:

(1) The money involved was petitioner's individual money and not the money of Lawrence Santos;

(2) The Government failed to prove transferee liability; and

(3) Decisions of this and other courts in several cases have decided the basic question here involved as not resulting in transferee liability.

(a) **The money received by the petitioner, Irmgard Santos, was her own money and not the money of the petitioner's husband, Lawrence Santos.**

The money, here involved, was the individual property of Irmgard Santos. The Tax Court's findings fully sustain this position. The evidence in the record removes any possible doubt that the property received by the petitioner was her separate property. The Tax Court's findings specifically state that petitioner had community income of \$154,976.51 and that the income tax thereon was \$70,289.91. (R. 52) The findings further shows that, when Lawrence Santos purchased the cashiers' checks in 1948, 1949, and 1950, he had assets in excess of \$200,000. (R. 54) No claim for additional taxes was made against Lawrence Santos until long after the cashiers' checks were purchased and delivered to petitioner. (R. 54)

Possibly, the best argument that can be made on this point is in Chief Judge Murdock's dissent in the case at bar which states, in part, as follows: (R. 64)

"The giving of the cashier's checks by Lawrence to the petitioner during the period when the community property laws were in effect would appear to be merely the receipt by the petitioner of a part of her share of community property rather than transfers of the separate property of Lawrence. Most of the checks were given during that period. I would not think that any transferee liability would result if the petitioner merely received a part of her share of the community funds during the period when the community property laws were in effect and eventually used those funds to pay her own taxes on her share of the community income."

In the present case \$80,000 face value of bonds were purchased with the cashiers' checks delivered to petitioner by her husband. One \$10,000 bond was sold in April 1952, and the proceeds used to pay the joint Territorial taxes of petitioner and her husband. The proceeds from the remaining \$70,000 in bonds were used to pay the

individual income taxes of petitioner. For some unexplained reason, the Commissioner did not assert a transferee liability on account of the proceeds from the \$10,000 bond although it must have been that the taxes paid were on the same income as the Federal taxes satisfied by payment of the proceeds of the \$70,000 in bonds.

The findings and the evidence in the case at bar clearly show (a) that the money which petitioner received was petitioner's money, (b) that the Commissioner recognized this fact by assessing the tax against petitioner individually and, (c) by releasing the liens after payment of the amount here involved in satisfaction of her individual tax liability.

**(b) The Government has failed to prove that the petitioner, Irmgard Santos, is a transferee of Lawrence Santos.**

The statute places the burden of proving transferee liability on the Commissioner. (See Appendix, p. 15) Any reasonable reading of the Tax Court's Findings of Fact shows that the Commissioner has not met that burden. The evidence makes this even more apparent but, for the purpose of this appeal, it is not necessary to go beyond the Tax Court's Findings of Fact.

The Government wholly failed to produce any evidence to show that the cashiers' checks were purchased with the separate funds of Lawrence Santos. It would have been a simple matter to have adduced proof on this point. Failure to do so gives rise to the inference that proof would have been unfavorable to the party with the burden of proof. The cashiers' checks were payable to Lawrence Santos and/or Irmgard Santos. A reasonable inference from the facts is that the checks represented community funds. This was the conclusion of Chief Judge Murdock in his dissenting opinion.

The findings are silent as to whether the community income was exhausted by payment of living expenses and community debts. However, the Tax Court opinion, (p. 59)

says this was so. There is absolutely no evidence to support such a statement. In addition, the Tax Court opinion (p. 59) says that the petitioner had the burden of going forward with evidence as to the living expenses and the source of their payment. Such a statement does violence to the statute which places the burden of showing transferee liability on the Government. It wholly failed to carry this burden. The Tax Court erred in placing this burden of proof on the petitioner.

The statute imposes upon the Commissioner the burden of showing that the money here involved was the property of Lawrence Santos. This is so because it is fundamental that "the mere distribution of assets does not of itself impose transferee liability upon the distributee because a transferee is one who takes the property of *another* without full, fair and adequate consideration; \* \* \*". (Emphasis supplied) *Shelton v. Gill*, (CA 4, 1953), 202 F. (2d) 503, 506.

**(c) The decisions hold that where a surviving spouse receives property held in joint tenancy or where spouses divide community property, there is no transferee liability.**

This Court has decided substantially the same question here involved. In *Tooley v. Commissioner*, (1941), 121 F. (2d) 350, 27 A.F.T.R. 686, the Commissioner determined that a joint tenant was the transferee of her deceased husband. The property involved was corporate stock which, although held by Mrs. Botts and her deceased husband as joint tenants, was administered in the estate of Mr. Botts. The probate court purported to distribute the stock to Mrs. Botts. This Court stated: (p. 360)

"We hold \* \* \* that the shares were not the property of Mr. Botts' estate, were not transferred to Mrs. Botts from that estate \* \* \*. Not only has the Commissioner failed to maintain his burden of proof that the shares were transferred to Mrs. Botts by the decree of distribution, but it is affirmatively shown to the contrary."



The case at bar is like the *Tooley* case in that the money being claimed was at all times the petitioner's money. To the same effect as the *Tooley* case, see *Parsons v. Anglim*, (CA 9, 1944) 143 F. (2d) 534, and *Irvine v. Helvering*, (CA 8, 1938), 99 F. (2d) 265.

Other cases decided by this circuit and dealing with the general question are *Rickenberg v. Commissioner*, (1949), 177 F. (2d) 114, certiorari denied 338 U.S. 949, and *Commissioner v. Mills*, (1950), 183 F. (2d) 32. In the *Rickenberg* case, a husband and wife transferred title to their community property to themselves as tenants in common. Upon the death of the husband, the Commissioner treated the transfer as in contemplation of death and asserted an estate tax. This Court reversed the Tax Court, which had sustained the action of the Commissioner.

The *Mills* case involved a situation where the Commissioner asserted a gift tax when a married couple in California divided their community property. This Court said there was no transfer of an interest in property and affirmed the Tax Court decision that there was no gift tax due. It seems to petitioner that the same basic principles apply in the case at bar.

These cases involve essentially the same issue as the one involved in this case. The petitioner received a part of her own separate property from her husband. Since the property received by the petitioner was her own property, she cannot be a transferee of her husband by reason of the receipt of such property.

## CONCLUSION

The petitioner received from her husband a part of her share of community property and her separately reported income. This was the petitioner's separate property. She used the money thus received to pay her separate taxes on her community income and her other separate income. The Commissioner has asserted transferee liability against



the petitioner for the tax liability of petitioner's husband by reason of said transfer to petitioner of her own property. The Tax Court's findings and the record in the Tax Court proceedings do not contain any evidence to support this asserted transferee liability against petitioner. The asserted transferee liability must fail because the Commissioner has not sustained the burden of proof imposed upon him by statute.

The decision of the Tax Court sustaining the Commissioner's determination of transferee liability should be reversed.

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March 26, 1957.

## APPENDIX

## Statutes and Regulations Involved

## Internal Revenue Code of 1939:

“Sec. 311. (a) Method of Collection.—The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection, and the provisions prohibiting claims and suits for refunds):

“(1) Transferees.—The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this chapter.

\* \* \* \* \*

“Any such liability may be either as to the amount of tax shown on the return or as to any deficiency in tax.”

## Regulations 111:

“Sec. 29.311-1. Claims in cases of transferred assets. (a) The amount for which a transferee of the property of a taxpayer is liable, at law or in equity \* \* \* in respect of any income tax imposed by chapter 1, whether shown on the return of the taxpayer or determined as a deficiency in the tax, shall be assessed against such transferee \* \* \* and collected and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by chapter 1, except as hereinafter provided. The provisions relating to delinquency in payment after notice and demand and the amount of interest attaching because of such delinquency, the authorization of distraint and proceedings in court for collection, the prohibition of claims for abatement and claims and suits for refund, the filing of a petition with The Tax Court of the United States, and the filing of a petition for review of the Tax Court's decision, are

included in the sections of the Internal Revenue Code (and regulations pertaining thereto) relating to deficiencies in tax imposed by chapter 1.

Sec. 1119. Provisions of Special Application to Transferees.

“(a) Burden of Proof. In proceedings before the Tax Court the burden of proof shall be upon the Commissioner to show that a petitioner is liable as a transferee of property of a taxpayer, but not to show that the taxpayer was liable for the tax.”



IN THE  
United States Court of Appeals  
For the Ninth Circuit

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IRMGARD SANTOS, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

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On Petition for Review of the Decision of the Tax Court of  
the United States

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BRIEF FOR THE RESPONDENT

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IN THE  
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IRMGARD SANTOS, *Petitioner*

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On Petition for Review of the Decision of the Tax Court of  
the United States

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BRIEF FOR THE RESPONDENT

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 46-65) are reported in 26 T.C. No. 71.

JURISDICTION

This review (R. 66-69) involves the transferee liability of taxpayer, Irmgard Santos,\* for the income

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\* The petitioner-transferee will be referred to as taxpayer throughout.

taxes of her husband, Lawrence Santos, transferor, for the taxable years 1943 to 1946, inclusive. On October 15, 1952, the Commissioner of Internal Revenue sent a deficiency notice to taxpayer as transferee of her husband, asserting a liability of \$68,287.90 representing a portion of his unpaid taxes for the years indicated. (R. 3.) On January 8, 1953, taxpayer filed a petition with the Tax Court for redetermination of the deficiency under the provisions of Section 272(a) of the Internal Revenue Code of 1939. Decision of the Tax Court was entered June 18, 1956. (R. 65-66.) Petition for review by this Court was filed September 7, 1956. (R. 66-69.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

### QUESTION PRESENTED

Whether the Tax Court correctly sustained the determination of the Commissioner of Internal Revenue that there was a transfer of the separate property of taxpayer's husband to taxpayer during periods when he was at all times insolvent so as to make taxpayer liable as a transferee under Section 311 of the Internal Revenue Code.

### STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statutes and Regulations involved are set forth in the Appendix, *infra*.

### STATEMENT

The facts as found by the Tax Court (R. 47-56) based on oral testimony (R. 71-174), exhibit (R. 174-200) and stipulations of the parties (R. 33-45) are stated below.



Taxpayer is a resident of the City of Honolulu, Territory of Hawaii. In 1928 she was married to Lawrence Santos of Honolulu. (R. 47.)

On October 15, 1952, the Commissioner mailed taxpayer, as transferee of assets of Lawrence Santos, a notice of deficiency in the amount of \$68,287.90. (R. 47.)

At the time taxpayer married Lawrence Santos they were both employed. Taxpayer was receiving a salary of \$125 a month, which was later increased to \$165 a month. Lawrence Santos was receiving a salary of \$175 a month, which was increased to \$200 a month. When Lawrence Santos started Persans, Limited, he had no assets other than the salaries of himself and wife. (R. 47.)

In 1937 Persans, Limited, a Hawaii corporation, was organized to engage in the retail shoe business in Honolulu. It was capitalized at \$20,000 and stock of the par value of \$5,000 was issued to Lawrence Santos, and dividends were paid to him individually; the balance of the outstanding stock of \$15,000 was issued to others. Lawrence Santos obtained the \$5,000 with which he acquired his shares by a loan from his uncle on a promissory note signed by Lawrence Santos and taxpayer, secured by a jointly executed mortgage on a house located on Oahu Avenue, Manoa Valley, Honolulu, owned by Lawrence Santos and taxpayer as joint tenants. This \$5,000 loan was repaid by Lawrence out of his joint checking account. (R. 48.)

Lawrence worked full time for Persans, Limited, and received a salary. Taxpayer worked at Persans on Saturdays and other days after she had completed her regular job, receiving no salary for such work. Lawrence gradually acquired, through purchase or

inheritance, all of the stock of Persans, Limited. (R. 47-48.)

In May, 1942, Lawrence purchased Manufacturers' Shoe Store in Honolulu for \$50,000. In December, 1942, he liquidated Persans, Limited, and the proceeds were paid to Lawrence Santos, doing business as an individual proprietor of Manufacturers' Shoe Store. (R. 48-49.)

On July 1, 1944, Lawrence Santos created an irrevocable trust by transfer to Hawaiian Trust Company, Limited, of the sum of \$70,000, the beneficiaries of the trust being the two children of Lawrence Santos and taxpayer. A limited partnership was organized in accordance with the laws of the Territory of Hawaii by and between Lawrence Santos, as general partner, and Hawaiian Trust Company, Limited, Trustee, under Deed of Trust dated July 1, 1944, as limited partner, for the purpose of acquiring at the close of business on June 30, 1944, all the assets of, and to carry on the business heretofore carried on and conducted by, Lawrence Santos under the name of Manufacturers' Shoe Store, in accordance with a limited partnership agreement between Lawrence Santos and Hawaiian Trust Company, Limited, dated as of July 1, 1944. Lawrence Santos transferred to such limited partnership all of his right, title, and interest in the assets of the business formerly carried on by him under the name of Manufacturers' Shoe Store, having a net book value of \$105,000, in exchange for a 60 per cent interest in such limited partnership, and Hawaiian Trust Company, Limited, as trustee, at the same time contributed the sum of \$70,000 and acquired ownership of a 40 per cent interest in such partnership. At the time of the creation of the limited part-

nership no share therein was given to taxpayer in recognition of any interest she might have or claim in the business formerly carried on as Manufacturers' Shoe Store or in the business of Persans, Limited. (R. 49-50.)

Effective June 1, 1945, the Territory of Hawaii adopted a community property law providing in part that all property, including earnings of the husband and wife, and rents, issues, income, and other profits of the separate property of the husband or wife acquired after marriage or the effective date of the act, whichever was later, shall be the community property of the husband and wife. Revised Laws of Hawaii 1945, c. 301A. This community property law was repealed effective June 30, 1949. Session Laws of Hawaii 1949, c. 301A. (R. 50.)

On March 1, 1947, Manufacturers' Shoe Company, Limited, was incorporated to take over the assets and liabilities of the limited partnership. The corporation was capitalized at \$350,000, Lawrence Santos receiving capital stock of the par value of \$210,000, and Hawaiian Trust Company, Limited, as trustee, receiving capital stock of the par value of \$140,000. (R. 50.)

In the early part of 1948 Lawrence Santos requested Cameron and Johnstone, auditors for the corporation and for the limited partnership, to determine what portion of the capital stock of \$210,000 issued to him at incorporation of Manufacturers' Shoe Company, Limited, represented earnings since June 1, 1945, i.e., that portion which represented community property. Cameron and Johnstone made an examination, and on April 5, 1958, advised Lawrence Santos that \$105,000 out of the \$210,000 was community property and that

his wife would be entitled to receive stock of the par value of \$52,500 in recognition of her community property interest in the earnings of the business from June 1, 1945, to February 28, 1947. On or about April 5, 1948, Lawrence Santos then transferred to taxpayer, as of March 1, 1947, capital stock of Manufacturers' Shoe Company of the par value of \$52,500 out of his share of the capital stock of the company, leaving him stock of the par value of \$157,500. (R. 50-51.)

From August, 1951, to June, 1952, taxpayer lived on the West Coast. She returned to Honolulu in June, 1952, and stayed until August, 1952, when she finally moved to California. In October, 1952, she filed an action in a California court for separate maintenance. Personal service, however, was never obtained on Lawrence Santos in such action. In December, 1953, she returned to Honolulu, where she is now living. (R. 51.)

Taxpayer's share of the community income of herself and Lawrence Santos for the period from June 1, 1945 (commencement of community property), to February 28, 1947 (the date of the organization of the corporation), was as follows (R. 51-52):

June 1, 1945 - December 31, 1945.....	\$ 15,621.92
January 1, 1946 - December 31, 1946..	54,400.31
January 1, 1947 - February 28, 1947...	41,564.78

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Total .....	\$111,587.01
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Taxpayer's share of the community income of herself and husband for the period from March 1, 1947, to July 1, 1949 (the end of community property), was as follows (R. 52):



March 1, 1947 - December 31, 1947....	\$ 11,610.60
January 1, 1948 - December 31, 1948..	21,063.38
January 1, 1949 - June 30, 1949.....	10,715.52
Total .....	<u>\$ 43,389.50</u>

Taxpayer's federal income tax liability on her community income as aforesaid for the taxable years 1945, 1946, 1947, 1948, and 1949 was \$5,240.96, \$28,257.97, \$27,384.49, \$6,165.16 and \$3,241.33, respectively. (R. 52.)

Taxpayer's aggregate community income during the community property period, after federal income tax liability, was \$84,686.60. (R. 52.)

Lawrence Santos purchased from Bishop National Bank cashier's checks payable to Lawrence Santos and/or Irmgard Santos, on the dates and in the amounts as follows (R. 52):

Date	Amount
April 15, 1948.....	\$ 14,000.00
April 16, 1948.....	12,328.80
November 16, 1948.....	15,000.00
May 13, 1949.....	10,718.77
May 16, 1949.....	13,547.14
August 8, 1950.....	10,448.84
September 18, 1950.....	6,229.12
Total .....	<u>\$ 82,272.67</u>

Lawrence gave the cashier's checks to taxpayer who retained them. In November, 1950, Lawrence went to California, and on November 22, 1950, he received the checks from taxpayer; Lawrence alone endorsed them and purchased \$80,000 principal amount of United States Treasury 2-1/2 per cent bearer bonds for the



total price of \$81,674.32. On November 27, 1950, Lawrence took delivery of the bonds and gave his receipt therefor. Lawrence delivered the United States Treasury bonds to taxpayer who retained them until sold. One \$10,000 bond was sold on April 1, 1952, and the proceeds were used to pay the joint territorial taxes of taxpayer and her husband. (R. 53.)

On March 27, 1952, taxpayer sold the bonds in the principal amount of \$70,000 for the total amount of \$68,287.90, and received checks in that amount payable to her order. Taxpayer endorsed the checks in favor of Smith, Wild, Beebe and Cades, of Honolulu, who deposited them in a trust account and then made a check payable to the Collector of Internal Revenue in the amount of \$68,287.90 in payment of the individual taxes asserted against taxpayer for the taxable years 1943 to 1947, inclusive, in the jeopardy assessments which had been levied against her. On April 4, 1952, a certificate of discharge of tax liens against taxpayer for the years 1943 to 1947, inclusive, was issued by the Collector of Internal Revenue and duly recorded. (R. 53.)

In the subsequent and final determination of taxpayer's individual income tax liabilities for the years 1943 to 1947, inclusive, which were at issue before the Tax Court of the United States in docket No. 42682 (not reported), it was determined that taxpayer had overpaid her income tax liabilities for the years 1945 and 1946 in the amounts of \$24,768.51 and \$38,237.18, respectively. (R. 53-54.)

The Manufacturers' Shoe Company, Limited, from the time of its incorporation on March 1, 1947, through the taxable year 1952, declared and paid dividends in each of the fiscal years ended February 28, 1949, and

February 28, 1951, in the amount of \$8,750. Taxpayer's pro rata share of the 1949 dividend from her aforesaid stockholdings in the corporation is included in the amount of her community income hereinabove set forth. (R. 54.)

The total value of the assets of Lawrence Santos as of December 31 of each of the following years was in the amount for each of such years as follows (R. 54):

Year	Amount
December 31, 1947.....	\$214,640.60
December 31, 1948.....	205,813.93
December 31, 1949.....	215,372.66
December 31, 1950.....	236,843.73
December 31, 1951.....	237,302.02
December 31, 1952.....	213,452.24

On December 26, 1951, the first assessment was made against Lawrence Santos with respect to federal income tax deficiencies for the years 1943, 1944, 1945, and 1946. An additional assessment was made on February 27, 1952. The unpaid liability of Lawrence Santos for federal income taxes and penalties, incurred but not assessed, at December 31 of the years 1948, 1949, 1950, 1951, and 1952, was \$415,427.73, plus interest. In addition to the aforesaid federal tax liabilities Lawrence Santos, as of December 31 of each of the years 1948, 1949, 1950, 1951, and 1952, was indebted to the Manufacturers' Shoe Store in the amounts of \$91,651.69, \$105,856.50, \$120,404.73, \$127,308.70, and \$127,511.70, respectively. (R. 54-55.)

For 1952 taxpayer and her husband filed separate income tax returns. Lawrence Santos claimed a loss on his return in the amount of \$4,244.94 incurred on

the sale in that year of the \$80,000 United States Treasury bonds here in question. Taxpayer reported no such transaction or loss on her individual returns although her attorney, who prepared her return, had knowledge that the bonds had been sold. On April 5, 1954, taxpayer filed a joint return for the year 1952. (R. 55.)

On April 4, 1950, the house at Halelea Place, Manoa Valley, Honolulu, owned by taxpayer and Lawrence Santos as joint tenants, was sold for \$21,000. After deduction of \$1,085.10 expenses, net proceeds were \$19,914.90. The Halelea Place house was purchased on September 23, 1941, for \$14,250, utilizing proceeds from the sale of the house on Oahu Avenue which had been owned by them as joint tenants and which had been sold on March 12, 1941. The Oahu Avenue house was purchased on July 26, 1937, utilizing proceeds from the sale of a house on Liliha Street, Honolulu, owned by the taxpayer and her husband as joint tenants. (R. 55-56.)

The Santos family consisted of taxpayer, her husband, and their two minor children. They maintained a home with over \$50,000 worth of furniture in it, and they operated three late-model automobiles. The family was maintained in a manner and style commensurate with the community income. (R. 56.)

During the period December 31, 1947, to December 31, 1952, Lawrence Santos was insolvent. (R. 56.)

The Tax Court also found as a fact the disputed matter on this appeal, namely, that during the period April 15, 1948, to March 27, 1952, Lawrence Santos gratuitously transferred to taxpayer his separate property having a value of at least \$68,287.90, and

that taxpayer is liable as transferee under Section 311 of the Internal Revenue Code to that extent. (R. 56.)

### SUMMARY OF ARGUMENT

Over a period of three years taxpayer's husband transferred certain assets to her, and the Commissioner asserted transferee liability because of these transfers. The only matter in contention is whether this represented a transfer of the separate property of the husband, or whether the operation of a community property statute enacted in Hawaii where the taxpayer and her husband lived vested taxpayer with an interest in the assets by operation of law.

It is Commissioner's position that the Tax Court was correct in finding that any community arising under this law was exhausted in the maintenance of the family. Consequently, any transfers to taxpayer must have been from the separate property of her husband, thus subjecting her to transferee liability.

While the Commissioner has been allocated the burden of proof in transferee cases, that burden was met in this case by showing the transfers were made while the transferor was insolvent and by showing facts from which it can be inferred that no community existed.

Even if the Tax Court's reasoning that the community was exhausted be rejected, the Hawaiian statute itself imposed upon the earnings of the husband and income from his separate property during the existence of the community liability for federal income taxes incurred before the effective date of the Act. Taxpayer received such assets subject to the paramount right of the Government and accordingly



was liable "at law" as a transferee under Section 311 of the 1939 Code.

Finally, even if the assets be viewed as community property, the community under Hawaiian law was subject to the payment of all debts incurred in the production of community income and the Government's right to reach community property for taxes incurred after the effective date of the Act cannot be circumvented by transfers to taxpayer. In such a situation she sustained transferee liability "at law" under Section 311 of the 1939 Code.

### ARGUMENT

**The Tax Court Correctly Held That There Was a Transfer of the Separate Property of Taxpayer's Husband to Taxpayer During Periods When He Was at All Times Insolvent So as to Make Taxpayer Liable as a Transferee Under Section 311 of the Internal Revenue Code of 1939**

The Tax Court found that over a period of three years beginning April 15, 1948 and ending September 18, 1950, taxpayer's husband, Lawrence Santos, purchased cashier's checks of the value of \$82,272.67 in the name of himself and taxpayer, and delivered these checks to the taxpayer. (R. 52-53.) On November 22, 1950, taxpayer returned the checks to her husband who, upon her request (R. 123), purchased \$80,000 face amount United States Treasury bearer bonds for the total price of \$81,674.32 and delivered them to taxpayer (R. 53). Further tracing of these funds revealed that on April 1, 1952 one \$10,000 bond was sold and the proceeds used to pay the joint territorial taxes of taxpayer and her husband. The remaining \$70,000 in bonds were later sold by taxpayer for \$68,287.90 and this amount was used to discharge her individual income tax liability for the years 1943 to 1947. (R. 53.)



Subsequently, in another proceeding in the Tax Court (Docket No. 42682, not reported) in which taxpayer's individual income tax liabilities for 1943 to 1947 were finally determined, it was stipulated that this was an overpayment of \$24,768.51 and \$38,237.18 for the years 1945 and 1946. (R. 54; Ex. 1A to Stip., R. 43.)

The undisputed facts further show that taxpayer's husband was insolvent at all times when such transfers were made because of federal income tax liability. (R. 40-41, 45, 56.)

Unquestionably, these facts without more would result in transferee liability. There was a transfer made while the transferor was insolvent and without consideration. However, in this case such liability is resisted on the grounds that the enactment of a community property law in Hawaii that was in force during part of the period when such transfers were made prevents this liability. The fallacies of this approach were dealt with in the Tax Court opinion (R. 56-65) and consequently will be elaborated here only briefly.

The Hawaiian community property statute became effective June 1, 1945, and remained in effect until June 30, 1949. (Material portions of this Act are set out in Appendix, *infra*.) The Act provided that all property separately owned at the effective date of the Act or the date of marriage, whichever was later, would continue as separate property. Also, it provided that earnings of the spouses, and all the rents, issues, incomes and other profits of the separate property of each shall be community property. Sections 1, 2 and 4, Revised Laws of Hawaii (1945), c. 301A, Appendix, *infra*; see also *McKay v. Commissioner*, 24 T.C. 86, construing these provisions.

At the effective date of the Act, June 1, 1945, taxpayer's husband owned 60 per cent of a limited partnership which had been formed on July 1, 1944, to carry on the business theretofore conducted by the husband since 1942 under the name of Manufacturers' Shoe Store. (R. 48-50.) In 1947 the business was incorporated and continued as a corporation throughout the community property period. (R. 50.) The earnings from this business constitute all of the community under discussion. Taxpayer's share of this community for the entire period during which the community property statute was effective was found to be \$154,976.51, and her federal income tax liability was \$70,289.91. (R. 38, 52.) From these undisputed facts the deductions of the Tax Court proceed as logically as simple mathematics. If taxpayer's share was \$154,976.51 the entire community was twice that amount or \$309,953.02. Deducting from this figure the aggregate federal income tax liability of \$140,579.82 and the \$105,000 commuted to the separate property of each spouse in 1948 (R. 50-51) the Tax Court found a total remaining community for the entire period of \$64,373.20 (R. 57-58).

The settled presumption, in the absence of contrary evidence, is that community expenses are paid from community property. *Huber v. Huber*, 27 Cal. 2d 784, 167 P. 2d 708; *In re Tomkins Estate*, 123 Cal. App. 670, 11 P. 2d 886; *Van Camp v. Van Camp*, 53 Cal. App. 17, 199 Pac. 885; *In re Cudworth's Estate*, 133 Cal. 462, 65 Pac. 1041; *Tinling v. Commissioner*, 7 T.C. 1393; *Van Vorst v. Commissioner*, 7 T.C. 826; *Oliver v. Commissioner*, 4 T.C. 684. The Tax Court applied this presumption because it nowhere appeared in the record from what funds community expenses were

taken, and the Hawaiian law expressly allowed community funds to be so used. Section 13(h), Revised Laws of Hawaii, 1945. (Appendix, *infra*.)

As to how much of the community was thus expended, the Tax Court carefully examined the material evidence and found inferentially at least, that the entire community was so exhausted, saying (R. 59):

The evidence shows that the Santos family consisted of taxpayer, her husband, and two minor children, and that they lived in a style and manner commensurate with their income. The Santos family lived in a home with over \$50,000 worth of furniture and operated three late-model automobiles. Their tax returns, which are in evidence, show that during the community period approximately \$9,000 was paid for Territorial income taxes.

The logic of the Tax Court's approach can scarcely be controverted. Only two types of property were recognized under the Hawaiian statute, separate and community. (c. 301A, Sections 1, 2, 4, Revised Laws of Hawaii (1945)). After demonstrating that the entire community was presumptively exhausted, it necessarily follows that any transfers to the taxpayer by her husband were from his separate property. As his separate property it was subject to payment of his taxes. In the hands of his wife it could be reached for his taxes through the transferee provisions in Section 311 of the Internal Revenue Code of 1939. (Appendix, *infra*.) Indeed, the original enactment of the substance of this section in the Revenue Act of 1926, c. 27, 44 Stat. 9, Section 280(a)(1), was designed *inter alia* to aid collection in the situation where "A husband may make a gift of the whole or part of his property to his wife." (S. Rep. No. 52, 69th Cong.,

1st Sess., p. 29 (1926) (1939-1 Cum. Bull. (Part 2) 332, 354; H. Conference Rep. No. 356, 69th Cong., 1st Sess., p. 43 (1926) (1939-1 Cum. Bull. (Part 2) 361, 371.)

Taxpayer's contention (Br. 9) that the \$82,272.67 given to her in 1948, 1949 and 1950 was her own share of community property is obviously erroneous. The Tax Court clearly demonstrated that there was only \$64,373.20 remaining in the community after part had been reduced to separate property and federal income taxes deducted from the remainder. (R. 57-58.) To contend that the \$82,272.67 is taxpayer's share of what was left of \$64,373.20 after payment of community expenses is contrary to facts proved with mathematical certainty. Some of the community property must have been used for community expenses which because of the style and manner of the Santos'es' living was demonstrated to be large and taxpayer was entitled to only one-half of whatever remained. After weighing the facts the Tax Court found that, presumptively, nothing remained in the community. (R. 59.) Unless this can be viewed as "clearly erroneous" it should not be disturbed on appeal. Rule 52(a), Federal Rules of Civil Procedure.

While it is true that the Commissioner has the burden of proof in transferee cases by the operation of Section 1119 of the 1939 Code, this burden was clearly met in the instant case. The burden thus placed on the Commissioner has been defined and the quantum of evidence necessary to satisfy it has been described by the courts.

In *Noell v. Commissioner*, 22 T.C. 1035, the transferee objected that the Commissioner had not proved insolvency. The Tax Court there said (p. 1042):



Although the burden of proof in transferee cases is on the respondent, the burden of going forward with the evidence is shifted to the petitioner *upon proof of gratuitous transfers*. \* \* \* Such transfers having been admittedly made in the instant case, a prima facie case of transferee liability was established and petitioner had the burden of showing Noell's solvency. (Emphasis supplied.)

In *Robinette v. Commissioner*, 139 F. 2d 285 (C.A. 6th), the court held a prima facie case had been made by proving receipt of assets in excess of that transferor's tax liability. To the same effect see *Gobins v. Commissioner*, 18 T.C. 1159, affirmed by this Court, 217 F. 2d 952, and *Hutton v. Commissioner*, 59 F. 2d 66 (C.A. 9th).

The instant case reveals a similar situation. By stipulated facts, documents and oral testimony it was established that there had been in excess of \$80,000 transferred to taxpayer. (R. 53.) The facts reveal that no consideration was given for such transfers, and that the transferor had at all material times been insolvent. (R. 52-55.) The only real question was whether the amounts transferred were community property or the separate property of the husband. On this issue, based on sound legal presumptions and logical inferences, the facts support the conclusion that there was no community available from which the transfers could have been made.

Even if the Tax Court's reasoning that the community was exhausted by the expenses of maintaining the family be rejected, its decision is still supportable on the express language of the Hawaiian statute.



Section 13(f) of the statute (Appendix, *infra*,) provides:

The earnings of the husband and the rents, issues, incomes and other profits of the separate property of the husband shall be liable for debts contracted by the husband prior to the inception of the community and the liabilities of the husband arising prior to the inception of the community out of tort or otherwise,

On June 1, 1945, the effective date of the Hawaiian statute, as shown by the letter accompanying the deficiency notice sent taxpayer (R. 5) Lawrence Santos had incurred income tax liabilities for 1943 and 1944 of \$177,847.27 and \$163,935.11. Under the express language of the statute it would appear that any subsequent earnings or income from the separate property of Lawrence Santos would be subject to this liability. Mr. Santos testified that most of the money given to taxpayer came from his salary and bonuses from his business. (R. 114). In view of these facts taxpayer took the money subject to the paramount claim of the Government under Hawaiian law and her transferee liability "at law" within the meaning of Section 311(a) of the 1939 Code was thus established.

That the taxes were not assessed until 1951 (R. 54) is of little consequence. Taxes incurred but not assessed are regarded as debts for the purpose of computing the insolvency of a transferor, and, it is submitted that the same rationale applies in determining pre-community debts under the Hawaiian statute. See *Scott v. Commissioner*, 117 F. 2d 36 (C.A. 8th); *Buzard v. Helvering*, 77 F. 2d 391 (C.A. D.C.); *Rubel v. Commissioner*, 74 F. 2d 27 (C.A. 6th).

Even assuming, arguendo, that the payments were made to taxpayer from the profits of her husband's business, and that such profits became community property and were not exhausted by community expenses, it is the Commissioner's position that transferee liability would still attach.

Part of Lawrence Santos' income tax liability for which taxpayer is being held as a transferee was for community property years. The deficiency letter (R. 5) indicates that for the years 1945 and 1946 taxpayer's husband's tax liabilities were \$105,588.98 and \$28,693.58, respectively. The inception of the Santos community was the effective date of the Act, June 1, 1945. Adding roughly one-half of the 1945 liability and all of the 1946 liability it is obvious that an amount far in excess of the asserted transferee liability of \$68,287.90 was incurred as an income tax liability during the community property years.

Under the express provisions of the Hawaiian statute (Section 13(c), Appendix, *infra*) community property is subject to the payment of debts and liabilities relating to the management, control, disposition of or other dealing with or for the benefit or protection of the community. This places Hawaii in accord with most community property states in holding that liabilities incurred in the production of income for the community are payable from community property. Indeed, it is the very essence of the community property system that community debts are payable from community property. See e.g. *Mauldin v. Mauldin*, 275 P. 2d 113 (Cal. App.); *Farmers Exchange National Bank v. Drew*, 48 Cal. App. 442, 192 Pac. 105; *Hearron v. Severyns*, 159 Wash. 486, 293 Pac. 458; *Strong v. Eakin*, 11 N.M. 107, 66 Pac. 539.

Thus, under the Hawaiian statute and the general rule the income taxes incurred by Lawrence Santos during community property years were debts of the community, and all the assets of the community were subject to its payment. It is only logical that if, as in the instant case, community property thus burdened were transferred to the separate property of one spouse that transferee liability should result "at law" under Section 311 of the 1939 Code.

Summarizing, it is the Commissioner's position on this appeal that the Tax Court's determination that there was no community is correct. Even if the Tax Court's method of reaching its conclusion is rejected, the same result follows under the Hawaiian statute, and even assuming that the transfer in question constituted a conveyance of community property, the liability of taxpayer as a transferee is nonetheless established.

### CONCLUSION

For the reasons above, the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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APRIL, 1957.

## APPENDIX

## Internal Revenue Code of 1939:

## SEC. 311. TRANSFERRED ASSETS.

(a) *Method of Collection*.—The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection and the provisions prohibiting claims and suits for refunds):

(1) *Transferees*.—The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this chapter.

\* \* \* \*

Any such liability may be either as to the amount of tax shown on the return or as to any deficiency in tax.

\* \* \* \*

(26 U.S.C. 1952 ed., Sec. 311.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.311-1. *Claims in Cases of Transferred Assets*.—The amount for which a transferee of the property of a taxpayer is liable, at law or in equity \* \* \* whether shown on the return of the taxpayer or determined as a deficiency in the tax, shall be assessed against such transferee \* \* \* and collected and paid in the same manner and



subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by chapter 1, except as hereinafter provided. The provisions relating to delinquency in payment after notice and demand and the amount of interest attaching because of such delinquency, the authorization of distraint and proceedings in court for collection, the prohibition of claims for abatement and claims and suits for refund, the filing of a petition with The Tax Court of the United States, and the filing of a petition for review of The Tax Court's decision, are included in the sections of the Internal Revenue Code (and regulations pertaining thereto) relating to deficiencies in tax imposed by chapter 1.

The term "transferee" as used in this section includes an heir, legatee, devisee, distributee of an estate of a deceased person, the shareholder of a dissolved corporation, the assignee or donee of an insolvent person, the successor of a corporation, a party to a reorganization as defined in section 112, and all other classes of distributees.

\* \* \* \*

Revised Law of Hawaii (1945):

Chapter 301A [as added by Act 273, Session Laws of Hawaii (1945)]. COMMUNITY PROPERTY.

Sec. 1. *Separate property of husband.* All property, both real and personal of the husband owned by him before marriage or before the effective date of this chapter, whichever is the later, and all property acquired by the husband thereafter by gift, devise, bequest or descent, and also all substitutions for any such property made at any time or from time to time, by sale or exchange or other disposition or by investment or otherwise, shall be his separate property.



Sec. 2. *Separate property of wife.* All property, both real and personal, of the wife owned by her before marriage or before the effective date of this chapter, whichever is the later, and all property acquired by the wife thereafter by gift, devise, bequest or descent, and also all substitutions for any such property made at any time or from time to time, by sale or exchange or other disposition or by investment or otherwise, shall be her separate property.

\* \* \* \*

Sec. 4. *Community property.* Except as otherwise provided in this chapter, all property, both real and personal, including earnings of the husband and earnings of the wife and including rents, issues, income and other profits of the separate property of the husband and rents, issues, income and other profits of the separate property of the wife, acquired by the husband or by the wife after marriage or on or after the effective date of this chapter, whichever is the later, shall be community property of the husband and wife, and each shall be vested with an undivided one-half interest therein. The respective interests of the husband and the wife in such community property shall be present, existing and equal interests. The respective interests of the husband and the wife in such community property shall arise as an incident of marriage.

Sec. 5. *Presumption of community property.* There shall be a rebuttable presumption that all property, both real and personal, acquired by the husband or by the wife after marriage or on or after the effective date of this chapter, whichever is the later, is community property.

Sec. 6. *Ownership of property by husband and wife.* A husband and wife may hold property as joint tenants, as tenants in common, as tenants by

the entirety, or as community property. There shall be a rebuttable presumption that all property, both real and personal, acquired by the husband and the wife after marriage or on or after the effective date of this chapter, whichever is the later, is community property, unless a different intention is expressed in the instrument by which the property is acquired.

Sec. 7. *Transfers—husband to wife and wife to husband.* The husband may give, grant, bargain, sell or convey directly to his wife, and the wife may give, grant, bargain, sell or convey directly to her husband, his or her community right, title, interest or estate in all or any community property, real or personal. Every such transfer made from the husband to the wife or from the wife to the husband shall operate to divest the property therein described of every claim or demand as community property, and shall vest the same in the transferee as the separate property of the transferee; *provided*, however, that no such transfer shall affect any equity in favor of creditors at the time of such transfer.

Sec. 8. *Control of husband's separate property.* The husband shall have the same right to manage, control, dispose of, and otherwise deal with his separate property as would be applicable with respect to his property generally were it not for the enactment of this chapter.

Sec. 9. *Control of wife's separate property.* The wife shall have the same right to manage, control, dispose of, and otherwise deal with her separate property as would be applicable with respect to her property generally were it not for the enactment of this chapter.

Sec. 10. *Control of community property.* The wife as agent for the community shall have the

same right as though it were her separate property to receive, manage, control, dispose of and otherwise deal with that portion of the community property which consists of her earnings, the rents, issues, income and other profits of her separate property and all other community property which shall stand in her name, subject to the limitations below listed. The husband as agent for the community shall have the same right as though it were his separate property to receive, manage, control, dispose of and otherwise deal with all other community property, including that portion of the community property which consists of his earnings, the rents, issues, income and other profits of his separate property and all other community property which shall stand in his name, subject to the limitations below listed. The limitations herein referred to are as follows: (1) Neither the husband nor the wife shall dispose of or encumber community real property or lease community real property for a longer period than one year unless the other shall join in the execution of the instrument. (2) Neither the husband nor the wife shall make any gift of community property or dispose of or encumber the same without a valuable consideration, without the consent of the other. (3) Neither the husband nor the wife shall dispose of or encumber the furniture, furnishings or fittings of the home, to the extent that the same constitute community property, without the consent of the other. (4) Neither the husband nor the wife shall have the right to devise or bequeath more than one-half of the community property. (5) The rights given to the husband and to the wife to manage, control, dispose of and otherwise deal with community property, as provided in this section, shall be exercised in good faith for the benefit of the community. In case of any violation by the husband or the wife of the above limitations

or any thereof, the person aggrieved shall be entitled to appropriate relief at law or in equity, according to the nature of the relief sought, and for such purpose the wife may sue or be sued by her husband in her own name and without the interposition of a next friend. The foregoing provisions shall not entitle the wife or the husband, by court proceedings or otherwise, to interfere with or affect the right of the other to collect his or her earnings or the rents, issues, income and other profits of his or her separate property.

\* \* \* \*

Sec. 13. Property subject to obligations. (a) The separate property of the wife shall be liable for debts contracted at any time by the wife and liabilities of the wife arising at any time out of tort or otherwise, including any such debts or liabilities by reason of any transaction entered into or action taken by the wife relating to the management or control or disposition of or other dealing with or for the protection or benefit of the community property, but shall not be liable for debts or liabilities of the husband.

(b) The separate property of the husband shall be liable for debts contracted at any time by the husband and liabilities of the husband arising at any time out of tort or otherwise, including any such debts or liabilities by reason of any transaction entered into or action taken by the husband relating to the management or control or disposition of or other dealing with or for the protection or benefit of the community property, but shall not be liable for debts or liabilities of the wife.

(c) The community property shall be liable for debts contracted by the husband or by the wife or by both, and for liabilities of the husband or the wife or both arising out of tort or otherwise, in any transaction entered into or action taken by



the husband or the wife or both relating to the management or control or disposition of or other dealing with or for the protection or benefit of the community property. With respect to the liability of community property for such debts and liabilities, no distinction shall be made between community property subject to the management and control of the wife and community property subject to the management and control of the husband.

(d) As between the community property and the separate property of the wife or of the husband the community property shall be liable for the debts and liabilities referred to in paragraph (c) of this section.

(e) The earnings of the wife and the rents, issues, incomes and other profits of the separate property of the wife shall be liable for debts contracted by the wife prior to the inception of the community and the liabilities of the wife arising prior to the inception of the community out of tort or otherwise.

(f) The earnings of the husband and the rents, issues, incomes and other profits of the separate property of the husband shall be liable for debts contracted by the husband prior to the inception of the community and the liabilities of the husband arising prior to the inception of the community out of tort or otherwise.

(g) As between the community property and the separate property of the wife or of the husband, the separate property shall be liable for the debts and liabilities referred to in paragraphs (e) and (f) of this section. For the purposes of said paragraphs (e) and (f) the inception of the community shall be the marriage of the husband and wife or the effective date of this chapter, whichever is the later.



(h) Nothing in this section shall be deemed to affect or modify the obligation of the husband to support his wife and family and to discharge all debts contracted by the wife for necessities for herself and family during marriage; *provided*, however, that if and whenever there is community property available for such purpose the husband shall be entitled to resort to such community property rather than to his separate property.

(i) Nothing in this section shall be deemed to prevent the wife or the husband from mortgaging or pledging her or his separate property or to prevent the wife and the husband from joining in a mortgage or pledge of community property as security for any indebtedness whether of the wife or of the husband or both.

Sec. 14. *Divorce—division of property.* In the event of the dissolution of marriage by decree of any court of competent jurisdiction, community property shall be divided between the parties by the court granting the decree, in such proportions as such court, from the facts in the case, shall deem just and equitable, and such division shall be subject to revision on appeal in all respects including the exercise of discretion by the court below.

\* \* \* \*

Sec. 16. *Prospective application only.* This chapter shall not be construed to operate retroactively and any right established or accrued and any action taken prior to the effective date of this chapter shall be governed by the law in force at the time such right was established or accrued or such action was taken.

\* \* \* \*

Sec. 18. *Effective date.* The effective date of this chapter shall be the first day of the first month following the month in which the act enacting this chapter is approved.

## Session Laws of Hawaii 1949:

## Chapter 301A. COMMUNITY PROPERTY.

Section 1. Sections 1, 2, 3, 4 and 6 of chapter 301A of the Revised Laws of Hawaii 1945, as enacted by Act 273 of the Session Laws of Hawaii 1945, are hereby repealed. Such repeal shall not operate to divest any interest in property which was acquired, established, accrued or vested prior to the effective date of this Act. Except as otherwise provided in this Act, any right established or accrued and any action taken prior to the effective date of this Act shall be governed by the law in force at the time such right was established or accrued or such action was taken.

Section 2. Every marital community existing pursuant to said *Chapter 301A* of the Revised Laws of Hawaii 1945 is hereby dissolved. Unless and until the property shall be transferred or converted into separate property, any property which is now held as community property pursuant to said chapter 301A, and the rents, issues, income and other profits thereof and all substitutions therefor, shall be held as community property and shall be governed by the provisions of said chapter 301A, as amended, subject to any disposition thereof pursuant to the provisions of said chapter 301A, as amended.

\* \* \* \*

Section 4. This Act shall take effect at midnight on June 30, 1949; \* \* \*



No. 15384

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

GEORGE VEGA-MURRILLO,

*Appellant,*

*vs.*

UNITED STATES OF AMERICA,

*Appellee.*

---

## APPELLEE'S BRIEF.

---

LAUGHLIN E. WATERS,

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FILED

APR 18 1957

PAUL P. O'BRIEN, CLERK





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No. 15384

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

GEORGE VEGA-MURRILLO,

*Appellant,*

*vs.*

UNITED STATES OF AMERICA,

*Appellee.*

---

## APPELLEE'S BRIEF.

---

### I.

#### Jurisdictional Statement.

This is an appeal from an Order of the United States District Court for the Southern District of California denying the motion of appellant to vacate a prior sentence and judgment in case No. 3313-ND. On April 5, 1955 appellant was sentenced to three consecutive terms totaling seven years for violations of Section 1324(a)(2), Title 8, United States Code.

The jurisdiction of the District Court is founded upon Section 3231, Title 18, U. S. C. The petition to vacate the original judgment was made by appellant under Section 2255, Title 28, U. S. C. The jurisdiction of the Court



of Appeals to entertain this matter may be found under the provisions of Section 1291, Title 28, U. S. C., and Rules 37 and 39 of the Federal Rules of Criminal Procedure.

## II.

### Statement of the Case.

Appellant was indicted by the grand jury for the Southern District of California on March 2, 1955, and was charged with three counts of violations of United States Code, Title 8, Section 1324(a)(2), illegal transportation of aliens. On March 21, 1955 appellant pleaded guilty to all three counts after consultation with his court-appointed counsel, Richard D. Love. The matter was thereupon referred to the Probation Officer for pre-sentence investigation and report, and continued until April 5, 1955 for sentence. On the latter date the court sentenced the appellant to three years on Count One, two years on Count Two, and two years on Count Three, the sentences to run consecutively. No appeal was taken from this judgment. Thereafter, on June 22, 1955, the appellant brought a motion under the provisions of Section 2255, Title 28, U. S. C., basing his motion upon the ground that while he was charged with three counts of transportation of aliens, actually the act of transportation was one, inasmuch as all three were in the same car. This motion was denied by the Court on March 10, 1956. No appeal was taken from this denial.

On May 8, 1956 the appellant filed a second petition under Section 2255, Title 28, U. S. C., and Rule 35 of

the Federal Rules of Criminal Procedure. [Clk. Tr. pp. 14-23.] The basis alleged in this petition was that appellant had been deprived of adequate representation by counsel as guaranteed by the Sixth Amendment, and had been coerced by appointed counsel, Richard D. Love, into pleading guilty. As in the previous motion, appellant also asserted that one transportation was involved although three were charged in the indictment.

On August 24, 1956 the appellant appeared before Judge Tolin on the second motion, and at that time was represented by David Marcus, counsel of his own choice. Although the Court had previously, on July 22, 1955, taken the testimony of Richard D. Love when his memory was reasonably fresh, he was again present on August 24, 1956, at which time he testified and was cross-examined by the attorney for appellant. Appellant testified at this hearing on his own behalf and was cross-examined by the Government. Following the hearing, findings of fact and conclusions of law were prepared and submitted, and were signed by the court on September 19, 1956. The court found, among other things, that the petitioner (appellant) was not a credible witness and not worthy of belief; that Richard D. Love was a credible witness worthy of belief; that petitioner was advised, prior to his entry of plea in the case, by his attorney as to the nature of the charge against him, his right of trial by jury, his right to use the power of the court to summon witnesses in his own behalf, his possible defenses, the maximum sentence provided by law, the consequences of

a plea of guilty, and the sentence which the court could impose upon such a plea. The court also found that the petitioner knew and understood the sentence which the court could impose upon his plea and the nature of the proceedings and charges against him. It further found that the petitioner entered his plea of guilty to each of the counts freely, voluntarily, and with full knowledge, understanding and appreciation of the sentence which the court might impose. The court concluded that petitioner was fully and properly represented by counsel in case No. 3313-ND, and that his constitutional right to representation by counsel was not denied him. The motion to vacate the prior sentence and judgment was therefore denied by Judge Tolin on September 19, 1956. Appeal has been taken from the denial of said motion.

III.  
ARGUMENT.

A. The Defendant Was Not Denied Due Process of Law nor the Equal Protection of the Laws, Inasmuch as He Was Not Deprived of Adequate Representation of Counsel Within the Purview of the Sixth Amendment.

Appellant's first specification of error alleges that he was denied the effective representation of counsel. Appellant was represented in the court below by Richard D. Love, of the Fresno, California, Bar. Mr. Love was Chairman of the Bar's Indigent Committee, and was appointed by Chief Judge Yankwich to represent the appellant at his arraignment proceedings on March 21, 1955. This was true, although the defendant had stated that he wished to proceed without an attorney. [Ex. A, p. 2.] After the appointment was made, the court permitted appellant and his attorney to consult on the matter before proceeding with the plea. The defendant was handed a copy of the Indictment. [Ex. A, p. 2.] On September 19, 1956 the court found "that Richard D. Love is a qualified attorney admitted to the practice of law in the federal court of the Southern District of California;" that he was a credible witness, a qualified attorney duly admitted to the practice of law before the federal court of the Southern District of California on March 21, 1955; that Richard D. Love was appointed by this court sitting in Fresno County, California, on March 21, 1955, to represent George Vega-Murrillo in the case of *United States v. George Vega-Murrillo*, No. 3313-ND; that petitioner was advised, prior to his entry of plea in case

No. 3313-ND, by Richard D. Love, as to the nature of the charge against him, his right of trial by jury, his right to use the power of the court to summon witnesses in his own behalf, his possible defenses, the maximum sentence provided by law, the consequences of a plea of guilty, and the sentence which the court could impose upon such a plea. The court also found appellant was not a credible witness, and not worthy of belief. [Clk. Tr. pp. 24-27.]

The appellant has not specified as error any of these findings of fact. The United States Circuit Court of Appeals for the Ninth Circuit, in Rule 18(2)(d) provides:

“In all cases when findings are specified as error, the specifications shall state as particularly as may be wherein the findings of fact and conclusions of law are alleged to be erroneous.”

No objection having been taken, appellant is bound by the findings of fact. *Lipscomb v. United States* (1954, 8th Cir.), 209 Fed. 831, 834-835. Despite this situation, appellant devotes almost his entire brief to a rambling dissertation setting forth testimony of the attorney and of the appellant, and his counsel's argument concerning the alleged denial of an effective right to counsel. (App. Br., pp. 7-44.) The effect is to argue the credibility of witnesses. In this portion of the appellant's brief counsel severely criticizes a fellow member of the Bar for alleged inept handling of the case. His contentions in this regard are based primarily on appellant's testimony, which the court found not to be worthy of belief; and upon counsel's arguments, which were not adopted by the court in its ultimate findings, conclusions and order.



The testimony of Mr. Love, which was found by the court to be credible, was that he did not recommend a guilty plea and that it was not his habit to do so. [Rep. Tr. pp. 15, 48.] He stated in effect he explored the facts fully. [Rep. Tr. pp. 59, 75.] He was satisfied appellant understood the charge. [Rep. Tr. pp. 45, 47.] He also advised appellant of the possible maximum penalty of five years on each count, which might run consecutively. [Rep. Tr. p. 52.] Thereupon appellant decided to plead guilty. [Rep. Tr. p. 52.] It is frequently asserted, after a proceeding has been completed, that the aggrieved party did not receive proper representation of counsel. In that regard this court has said:

“The position is taken by appellant that he was inadequately represented by counsel appointed by the court. However, it has been many times held that hindsight is not the proper measure for determining this question, and it has as often been held that the Constitution does not guarantee that counsel appointed for, or employed by, a defendant shall measure up to his notions of ability or competency. It is said in *Loisieu v. United States*, 177 F. 2d 919, that it is enough that the trial court appointed a qualified attorney to represent petitioner and that the attorney appeared, advised with, and represented him.” *Sherman v. United States* (9 Cir., No. 14977, January 22, 1957), ..... F. 2d ....., at page 11 of slipsheet opinion.

A leading commentary on contentions that counsel did not afford a defendant the degree of protection which is guaranteed him under the Sixth Amendment is contained in *Latimer v. Cranor* (1954, 9 Cir.), 214 F. 2d 926, where Chief Judge Denman stated at page 929:

“The application alleges that Latimer’s attorney mishandled his case.

“This is a frequent contention of unsuccessful defendants. There are no allegations showing the attorney’s conduct was so incompetent that it made the case a farce requiring the court to intervene in his client’s behalf. We find no denial of the efficient representation of the Constitution.”

Other cases to the same effect are: *Losieau v. United States* (1949, 8 Cir.), 177 F. 2d 919; *Conley v. Cox* (8 Cir.), 138 F. 2d 786, 787; *United States ex rel Feeley v. Ragen* (1948, 7 Cir.), 166 F. 2d 976; *Moss v. Hunter* (1948, 10 Cir.), 167 F. 2d 683; *United States v. Wight* (1949, 2 Cir.), 176 F. 2d 376, 379; *Shepperd v. Hunter* (1947, 10 Cir.), 163 F. 2d 872, 873; *Williams v. United States* (1954, 4 Cir.), 218 F. 2d 276, 279-280; *Hayman v. United States* (1953, 9 Cir.), 205 F. 2d 891, 894.

The hearing on August 24, 1956 was an adversary proceeding before the court. Both sides were represented by counsel. Both sides had an opportunity to offer evidence and to cross-examine the witnesses. The trial court thereupon made findings regarding the credibility of the witnesses involved and came to a final conclusion. There was a definite conflict between the testimony of the attorney Love and appellant Vega-Murrillo. The court did not believe appellant. Under these circumstances the appellate court should not lightly disturb the trial court’s result. Rule 52(a) Federal Rules of Civil Procedure; *Hancock v. Eck*, 183 F. 2d 632; *Oedecker v. Muncie Gear Works, Inc.*, 179 F. 2d 821, 824. The trial court has had the opportunity to observe the demeanor of the witnesses and to determine which to believe. The appellate court does not have that advantage.

However, an examination of the record is revealing as to the credibility of appellant. In paragraph VIII of

the motion filed May 8, 1956 the appellant states: "That at no time was the defendant served with a copy of the indictment." [Clk. Tr. p. 16.]

The record of the court shows that the Clerk handed a copy of the Indictment to appellant on March 21, 1955 at the time of his arraignment. [Ex. A, p. 2, line 9.]

In his earlier petition filed June 22, 1955 appellant makes the following representation:

"The petitioner was not advised by counsel that each person was to be a count against him, or that he would be sentenced on each count, and therefore entered the plea of guilty, waiving all burden of proof to be established by the United States Attorney, and therefore contends that he did not receive the best efforts of his counsel and is entitled to a redress of this sentence." [Clk. Tr. p. 7, lines 11-17.]

Despite this allegation, appellant under oath testified on August 24, 1956 that the attorney said to him, "You know you can get 15 years." (App. Br., p. 19, lines 5-6.) This shows that appellant was advised of the maximum sentence of fifteen years which could be imposed by three consecutive sentences under Title 8, Section 1324(a)(2), United States Code. The maximum under each count is five years.

Thus, in his own record appellant shows that he is not one worthy of belief, and that he is a person who is likely to say whatever may seem desirable to achieve the end which he seeks at the time.

He took advantage of the court by claiming the right to representation by a member of the *indigent* defense panel. Nonetheless, his own testimony on August 24, 1956 was that after sentence he sent an offer to his attorney,

Love, of \$100.00 to assist him further in the matter, and did obtain \$50.00 to this end. [Rep. Tr. p. 111.] He was, therefore, not entitled to the free legal assistance which he now attacks.

In addition to all the foregoing, the court had before it at the hearing the files of two previous criminal actions showing felony convictions involving illegal smuggling of aliens by appellant. [Rep. Tr. p. 142.] The previous record was admitted by appellant while on the stand. [Rep. Tr. pp. 131, 140.] Appellant's probation was revoked in one instance. [Rep. Tr. p. 136.] These factors could be considered by the court in assessing appellant's credibility as a witness at the hearing.

It is the position of the appellee that the record clearly shows on its face that appellant did have proper representation of counsel. The entire record shows it. The findings of the court to this effect have not been attacked. Those findings of fact should be binding on this appeal where the evidence, as here, supports them.

#### **B. Congress Has the Power to Regulate the Transportation of Aliens Within the Respective States.**

Appellant's second point is based on a claim that here is an intrastate transportation of aliens illegally in the country, and that by virtue of the intrastate phase, Congress has no power to regulate such transportation. Such a conclusion is manifestly unjustified. For example, there is a long line of authority dealing with the federal regulation of railroad tariffs and rates, including intrastate regulations necessary to the proper exercise of interstate powers of regulation. See, for instance: *Wabash, St. Louis & Pacific Railway Co. v. Illinois* (1886), 118 U. S. 557; *Morgan v. Commonwealth of Virginia* (1946), 328 U. S. 373; *Leisy v. Hardin* (1890), 135 U. S. 100; *The*

*Shreveport cases*, 234 U. S. 342; *Railroad Commission of Wisconsin, et al. v. Chicago, Burlington & Quincy RR.* (1922), 257 U. S. 563; and *In re Rahrer* (1891), 140 U. S. 545. The proposition established in all of these cases is, to quote *In re Rahrer*, at 555: "The power of Congress to regulate commerce among the several States, when the subjects of that power are national in their nature, is also exclusive." Inasmuch as Article I, Section 8, of the Constitution of the United States gives to the Congress power to regulate interstate and foreign commerce, and further, to provide a uniform rule of naturalization, it certainly follows that the traffic in aliens within the boundaries of the United States is one requiring a uniform system of regulation, and, as such, is obviously within the purview of the powers of Congress, even though the specific act complained of is an entirely intrastate transportation of an alien illegally in this country.

To say that Congress is without power to control trafficking in illegal aliens for the fortuitous happenstance that the particular traffic occurred entirely within one state is to ascribe an impotence to the Government of the United States which reason can neither countenance nor commonsense subscribe.

In this regard compare the White Slave Traffic cases where the victim gets out of the automobile transporting her and walks across the State border, and then resumes her journey in the automobile after the vehicle has crossed the State line. *Mellor v. United States* (1947), 160 Fed. 757, c. d. 331 U. S. 848, 67 S. Ct. 1734, 91 L. Ed. 1858. It is all a part of the proscribed interstate traffic for immoral purpose, although the accused did not actually transport the victim across the line.



As a part of this specification of error appellant contends that Section 1324(a)(2) of Title 8, United States Code, is contrary to and contravenes Article IV, Section 2, of the Constitution of the United States (the privileges and immunities of citizens of each state); and that it is contrary to and contravenes the Ninth and Tenth Amendments of the Constitution, to-wit: Article IX, the enumeration in the Constitution of certain rights shall not be construed to deny or disparage others retained by the people. Article X, the powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people. The foregoing points, while set out in appellant's brief, are not argued or supported by citation. The contentions are manifestly unsound. The failure to argue them is, in effect, a waiver. *Kimball Laundry Co. v. United States* (1948, 8 Cir.), 166 F. 2d 856, 859, where it is stated:

“An unargued assertion of error is no more helpful to an appellate court than is an unsupported allegation of fact to a trial court. The burden of demonstrating error is upon an appellant, and errors assigned, but not argued in his brief, are waived.” (Citing cases.)

**C. The Court Was Correct in Sentencing the Defendant Consecutively on the Three Counts of the Indictment.**

Appellant's third point on appeal is to the effect that there having been a single transportation of the three aliens, only one sentence could be imposed under Section 1324(a)(2), Title 8, United States Code. No appeal was taken from the sentence. Furthermore, it was a point which was raised in defendant's motion dated June 22, 1955, and denied by the order of the court on March

30, 1956. [Clk. Tr. p. 13.] No appeal was taken from the denial of this motion.

However, treating the matter on the merits, it is clear that the appellant's contention is based primarily on the case of *Bell v. United States*, 349 U. S. 81, which is a Mann Act case. In that situation, after the trial court and the Circuit Court had upheld a sentence imposing consecutive penalties for a single transportation involving two women, the Supreme Court said at pages 82-83:

"The punishment appropriate for the diverse federal offenses is a matter for the discussion of Congress, subject only to constitutional limitations, more particularly the Eighth Amendment. *Congress could no doubt make the simultaneous transportation of more than one woman in violation of the Mann Act liable to cumulative punishment for each woman so transported.* The question is: Did it do so? It has not done so in words in the provisions defining the crime and fixing its punishment. Nor is guiding light afforded by the statute in its entirety or by any controlling gloss. The constitutional basis of the statute is the withdrawal of 'the facility of interstate transportation.' . . ." (Emphasis supplied.)

It is apparent that the Supreme Court bases its decision in the foregoing case upon the statutory construction and, in effect, finds that the Mann Act, 18 U. S. C., Section 2421, makes the act of transportation determinative, rather than the number of persons transported. This is not true of the Act for which the appellant is charged. A comparison of the statute reveals that the Mann Act states:

"Whoever knowingly transports in interstate or foreign commerce, or in the District of Columbia or in any Territory or Possession of the United States,

any woman or girl for the purpose of prostitution or debauchery, or for any other immoral purpose, or with the intent and purpose to induce, entice or compel such woman or girl to become a prostitute or to give herself up to debauchery, or to engage in any other immoral practice, . . . shall be fined not more than \$5,000.00 or imprisoned not more than five years, or both."

The Act under which the appellant is charged, Section 1324(a)(2), Title 8, United States Code, provides:

"(a) Any person, including the owner, operator, pilot, master, commanding officer, agent, or consignee of any means of transportation who— . . .

"(2) knowing that he is in the United States in violation of law, and knowing or having reasonable grounds to believe that his last entry into the United States occurred less than three years prior thereto, transports, or moves, or attempts to transport or move, within the United States by means of transportation or otherwise, in furtherance of such violation of law; . . .

"any alien, including an alien crewman, not duly admitted by an immigration officer or not lawfully entitled to enter or reside within the United States under the terms of this chapter or any other law relating to the immigration or expulsion of aliens, shall be guilty of a felony, and upon conviction thereof shall be punished by a fine not exceeding \$2,000.00 or by imprisonment for a term not exceeding five years, or both, *for each alien in respect to whom any violation of this subsection occurs.* . . ."

(Emphasis supplied.)

From a comparison of these two sections, it is obvious that Section 1324, Title 8, U. S. C., is distinguishable

from the provision of the White Slave Traffic Act, in that the punishment is provided for *each* alien in respect to whom any violation of the subsection occurs. Such is not true under the Mann Act. Accordingly, the contention of appellant with regard to the applicability of the *Bell* case is without merit.

Under this ground of appeal, appellant makes the point that the prosecutor can only cull one offense out of a single criminal act. In this connection, the language of *Sherman v. United States* (9 Cir., No. 14977, Jan. 22, 1957), ..... F. 2d ....., at page 8 of the slipsheet opinion, says:

“It is true that each of the three offenses were part of a general plan but each had a separate genesis and separate train of events leading to culmination. Without further comment on the cases cited by appellant in support of his single transaction theory, we point out that the law is well established, that even if there be any substance to the single transaction rule, it does not apply in the federal courts.”

The court in *Reynolds v. United States*, 280 Fed. 1, commented on the so-called “single transaction” rule as follows:

“The sole contention of plaintiff in error here (although stated in two forms) is that she has been twice punished for a single offense, invoking in support of that contention, divers holdings of state courts under what is called the ‘same transaction’ rule. This broad rule does not prevail in the courts of the United States, wherein it is well settled that it is competent for Congress to create separate and

distinct offenses growing out of the same transaction.’ ”

See *Gavieres v. United States*, 220 U. S. 338;

*Pereira v. United States*, 347 U. S. 1;

*Matthews v. Swope* (9 Cir., 1940), 111 F. 2d 697.

Congress has seen fit to legislate a punishment for each alien in respect to whom any violation of Subsection 1324(a) occurs. The contention of appellant must therefore be rejected.

#### IV.

#### Conclusion.

1. The finding of the trial court that the appellant had the effective representation of counsel should not be disturbed. The credibility of the witnesses was determined in favor of the Government. The defendant has failed to show that he was denied due process.

2. Section 1324(a)(2), Title 8, United States Code, is a constitutional regulation of the transportation of aliens illegally within the United States. Incident to Congress' right to regulate commerce and to provide a uniform rule of naturalization, regulation of the movements of aliens illegally within the United States, or any part thereof, is properly the subject of congressional legislation.

3. The court properly sentenced the defendant to consecutive sentences for the transportation of each alien, in accordance with the specific provisions of Section 1324(a) of Title 8, United States Code.



Wherefore the Government respectfully requests that the order and judgment of the trial court denying defendant's motion under Section 2255, Title 28, United States Code, be affirmed.

Respectfully submitted,

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Assistant Chief, Criminal  
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United States of America.*



No. 15386

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United States  
Court of Appeals  
for the Ninth Circuit

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F. NORMAN PHELPS and ALICE PHELPS,  
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

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Transcript of Record

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Petition to Review a Decision of the Tax Court of the  
United States

FILED

MAR 12 1957

PAUL P. O'BRIEN, CLERK



No. 15386

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United States  
Court of Appeals  
for the Ninth Circuit

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F. NORMAN PHELPS and ALICE PHELPS,  
Petitioners,  
vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

---

Transcript of Record

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Petition to Review a Decision of the Tax Court of the  
United States

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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## NAMES AND ADDRESSES OF ATTORNEYS

W. P. THAYER,

523 West 6th Street,

Los Angeles, California,

Attorney for Petitioner.

CHARLES K. RICE,

Assistant Attorney General,

LEE A. JACKSON,

Attorney,

Department of Justice,

Washington 25, D. C.,

Attorneys for Respondents.



The Tax Court of the United States

Docket No. 51282

F. NORMAN PHELPS and ALICE PHELPS,  
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

Appearances:

For Petitioner:

Wellman P. Thayer, Esq.

Arthur H. Deibert, Esq.

William L. Kumler, Esq.

H. B. Thompson, Esq.

For Respondent:

Mark Townsend, Esq.

DOCKET ENTRIES

1953

Nov. 17—Petition received and filed. Taxpayer notified. Fee paid.

Nov. 18—Copy of petition served on General Counsel.

1954

Jan. 5—Answer filed by General Counsel.

Jan. 5—Request for hearing in Los Angeles filed by General Counsel.

Jan. 13—Notice issued placing proceeding on Los Angeles calendar. Service of answer and request made.

1955

Feb. 8—Hearing set April 25, 1955, Los Angeles.

Apr. 29—Hearing had before Judge Turner on petitioner's motion to continue generally on the Los Angeles, California, calendar. Motion granted, filed at hearing. Copies served.

May 16—Transcript of hearing 4/29/55 filed.

Aug. 4—Hearing set November 28, 1955, Los Angeles.

Aug. 16—Joint motion to place proceeding on the 9/12/55 Los Angeles, California, calendar, filed. 8/17/55 granted.

Aug. 18—Hearing set September 12, 1955, at Los Angeles.

Sept. 12—Hearing had before Judge Raum on the merits; on parties' written motion to consolidate with Dockets 51216 and 51265, granted. Stipulation of facts and exhibits 1A through 23X, and motion for consolidation, copies served, filed at hearing. Petitioner's brief 10/27/55, Respondent's brief 11/28/55, Petitioner's reply 12/19/55.

Oct. 20—Motion for extension of 45 days to file brief filed by taxpayer. 10/20/55 granted to 11/28/55.

Oct. 26—Transcript of hearing 9/12/55 filed.

Nov. 29—Brief filed by taxpayer. 11/30/55 copy served.

1955

Dec. 27—Motion for extension to January 28, 1956 to file brief, filed by respondent. 12/29/55 granted.

1956

Jan. 27—Motion for extension to February 6, 1956 to file brief, filed by respondent. 1/30/56 granted.

Feb. 6—Answer brief filed by respondent.

Mar. 5—Motion for extension of time to 3/21/56 to file reply brief, filed by petitioner. 3/5/56 granted.

Mar. 26—Motion for leave to file reply brief, reply brief lodged, filed by petitioner. 3/27/56 granted. 3/28/56 served.

July 19—Findings of fact and opinion filed, Raum, J. Decision will be entered for respondent. Served 7/19/56.

July 31—Decision entered, Judge Raum, Division 11. Served 8/1/56.

Oct. 25—Petition for review by United States Court of Appeals, Ninth Circuit, with assignments of error filed by petitioner.

Oct. 31—Proof of service filed.

Nov. 13—Designation of contents of record on review with proof of service thereon, filed by petitioner.

Nov. 14—Designation of additional portions of record with proof of service filed.



[Title of Tax Court and Cause.]

## PETITION

The above named petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (ARC - Ap:SF:LA - 90D:PAK), dated August 19, 1953, and as a basis of this proceeding allege as follows:

1. The petitioners are individuals residing at 66 Hampton Road, Piedmont, California. The return for the period herein involved was filed with the Collector for the First Collection District of California.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioners on August 19, 1953.

3. The deficiencies as determined by the Commissioner are in income taxes for the calendar year 1948 in the amount of \$107,926.06, of which the entire amount is in dispute.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in determining that the 1948 distribution indicated opposite the following named corporations were taxable dividends within the meaning of Section 115(g) of the Internal Revenue Code.

Capitol Chevrolet Co. ....	\$ 75,518.30
Howell Chevrolet Co. ....	46,508.00
Mid-Valley Chevrolet Co. ....	74,340.50
	<hr/>
	\$196,366.80

(b) The Commissioner erred in failing to find that the distributions itemized in paragraph (a) hereof were distributions in partial liquidation, redemption and cancellation of the following shares of stock in the indicated corporations which shares were owned by the petitioners.

Capitol Chevrolet Co. ....	130 shares
Mid-Valley Chevrolet Co. ....	130 shares
Howell Chevrolet Co. ....	100 shares

(c) The Commissioner erred in determining that there was a deficiency of income tax for the calendar year 1948 in the amount of \$107,926.06.

5. The facts upon which petitioners rely as the basis of this proceeding are as follows:

(a) On or about April 1, 1946 Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. were incorporated under the laws of the State of California. At that time petitioners were issued stock of said corporations in the amounts indicated and for the cash consideration shown.

Capitol Chevrolet Co. ....	170 shares	\$13,000.00
Mid-Valley Chevrolet Co. ....	153 shares	\$13,000.00
Howell Chevrolet Co. ....	120 shares	\$10,000.00

(b) At all times herein material, Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. operated as retail dealers in the sale of Chevrolet motor cars under franchise with Chev-

rolet Motor Division of General Motors Corporation. By identical letters, dated November 1, 1948, addressed to Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co., the local Zone Manager of the Chevrolet Motor Division of General Motors Corporation advised each of the respective corporations that their operations were unsatisfactory in that some of the stock of each of said corporations was held by James A. Kenyon, Trustee for Patricia May Kenyon, the beneficiary not being an operating participant in the business. Said letters further provided that delivery of the selling agreements or franchises enclosed therewith was conditioned upon the elimination of said Trust from proprietary interests in said corporations not later than April 30, 1949.

(c) Concurrently with the receipt of the aforesaid letter from Chevrolet Motor Division, James A. Kenyon and F. Norman Phelps, shareholders in said corporations, were advised by the local Zone Manager of Chevrolet Motor Division that it was the desire of Chevrolet Motor Division that James A. Kenyon and F. Norman Phelps continue their proprietary participations in the three corporations in the same ratio as they had theretofore participated.

(d) Accordingly, meetings of the Board of Directors of said corporations were held on December 21, 1948, at which resolutions for partial liquidation of said corporations were adopted, authorizing the corporations to reduce their stated capital and to redeem and cancel the following shares:

Capitol Chevrolet Co. ....	260 shares
Mid-Valley Chevrolet Co. ....	260 shares
Howell Chevrolet Co. ....	100 shares

(e) Alternatively, the plans of partial liquidation provided that if James A. Kenyon could obtain court authorization he would purchase from the Patricia May Kenyon Trust the following shares of said corporations and the corporations would redeem, retire and cancel so much of the remaining stock as would be necessary to equalize the interests of Messrs. James A. Kenyon and F. Norman Phelps.

Capitol Chevrolet Co. ....	40 shares
Mid-Valley Chevrolet Co. ....	40 shares
Howell Chevrolet Co. ....	20 shares

(f) Thereafter James A. Kenyon filed with the Superior Court of Los Angeles County a petition seeking authorization as an individual to purchase for himself as trustee of the Patricia May Kenyon Trust the following shares of common capital stock.

Capitol Chevrolet Co. ....	40 shares
Mid-Valley Chevrolet Co. ....	40 shares
Howell Chevrolet Co. ....	20 shares

However, because all of the contingent remaindersmen could not be located and served said authorization could not be obtained.

(g) Therefore, pursuant to said plans of partial liquidation theretofore adopted by the respective corporations as aforesaid, distributions in redemption and cancellation of the stocks of said corporations were made as follows insofar as your petitioners were concerned:

		Amt. Received
130 shares	Capitol Chevrolet Co. ....	\$ 75,518.30
130 shares	Mid-Valley Chevrolet Co. ....	74,340.50
100 shares	Howell Chevrolet Co. ....	46,508.00
		<hr/>
		\$196,366.80

(h) Petitioners properly reported the gain realized from the redemption of said stocks on their 1948 Federal income return as follows:

Name of Corporation	Amount Received	Stock Claimed	Gain Reported
Capitol Chevrolet Co.	\$ 75,518.30	\$13,000.00	\$ 62,518.30
Howell Chevrolet Co.	46,508.00	10,000.00	36,508.00
Mid-Valley Chevrolet Co.	74,340.50	13,000.00	61,340.50
		<hr/>	<hr/>
Totals	\$196,366.80	\$36,000.00	\$160,366.80

Wherefore, the petitioners pray that this Court may hear the proceeding and determine that there is no deficiency in income taxes for the calendar year 1948.

Dated: November 2, 1953.

Respectfully submitted,

/s/ WELLMAN P. THAYER,

/s/ ARTHUR H. DEIBERT,

/s/ WILLIAM L. KUMLER,

/s/ H. B. THOMPSON,

Counsel for Petitioners

Duly Verified.



EXHIBIT "A"

1250 Subway Terminal Bldg., 417 South Hill St.,  
Los Angeles 13, California

ARC-Ap:SF LA:90D:PAK

Aug. 19, 1953

Mr. F. Norman Phelps and Mrs. Alice Phelps  
Husband and Wife

1300 K Street, Sacramento 14, California

Dear Mr. and Mrs. Phelps:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1948 discloses a deficiency of \$107,-926.06, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute, in duplicate, the enclosed form and forward it to the Assistant Regional Commissioner, Appellate, 1250 Subway Terminal Build-

ing, 417 South Hill Street, Los Angeles 13, California. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours,

T. Coleman Andrews,

Commissioner of Internal Revenue

/s/ By W. T. Tignor,

Associate Chief Appellate Division

PAKar:vmc—Enclosures: Statement, Form 1276,  
Agreement Form.

### Statement

Tax Liability for the Taxable Year Ended  
December 31, 1948

Year	Deficiency
1948	
Income Tax .....	\$107,926.06

In making this determination of your income tax liability careful consideration has been given to the report of examination dated November 23, 1951, to your protest dated April 23, 1952, and to the statements made at hearings held on May 2, 1952 and May 4 and 19, 1953.

A copy of this letter and statement has been mailed to your representative, Mr. H. B. Thompson, 1104 Pacific Mutual Building, Los Angeles 14,

California, in accordance with the authorization contained in the power of attorney executed by you.

### ADJUSTMENTS TO NET INCOME

Taxable Year Ended December 31, 1948

Net income as disclosed by return.....	\$193,680.54
Additional income:	
(a) Income from dividends .....	196,366.80
<b>Total.....</b>	<b>\$390,047.34</b>
Reduction:	
(b) Long-term capital gain eliminated.....	\$ 80,183.40
<b>Net income adjusted.....</b>	<b>\$309,863.94</b>

### EXPLANATION OF ADJUSTMENTS

(a) and (b) In your return there is reported capital gains amounting to \$160,366.80, of which 50% or \$80,183.40 was included in income as long-term capital gain, arising from distributions in alleged partial liquidation of stocks of corporations, as shown in the following:

Name of Corporation	Amount		Gain
	Received	Stock Claimed	Reported
Capitol Chevrolet Co.	\$ 75,518.30	\$13,000.00	\$ 62,518.30
Howell Chevrolet Co.	46,508.00	10,000.00	36,508.00
Mid-Valley Chevrolet Co.	74,340.50	13,000.00	61,340.50
<b>Totals</b>	<b>\$196,366.80</b>	<b>\$36,000.00</b>	<b>\$160,366.80</b>

It is determined that said distributions were essentially equivalent to the distributions of taxable dividends within the meaning of section 115(g) of the Internal Revenue Code.

Accordingly, the amount of such distributions, aggregating \$196,366.80, is added to your income as representing dividends received and the amount of long-term capital gain, \$80,183.40, reported in your return from such transactions is eliminated from income.

## COMPUTATION OF ALTERNATIVE TAX

Taxable Year Ended December 31, 1948

Net income adjusted .....	\$309,863.94
Less: Excess of net long-term capital gain over net short-term capital loss .....	5,000.00
Ordinary net income .....	\$304,863.94
Less: Exemptions .....	3,000.00
Balance, subject to surtax and normal tax.....	\$301,863.94
One-half of \$301,863.94 .....	\$150,931.97
Tentative surtax .....	\$108,130.81
Tentative normal tax at 3%.....	4,527.96
Total .....	\$112,658.77
Less reduction under Sec. 12(c), I.R.C. ....	13,254.23
Partial tax on one-half of net income.....	\$ 99,404.54

## COMPUTATION OF ALTERNATIVE TAX

Taxable Year Ended December 31, 1948

Combined partial tax (\$99,404.54 x 2).....	\$198,809.08
Plus: 50 per cent of \$5,000.00.....	2,500.00
Combined alternative tax .....	\$201,309.08

## COMPUTATION OF TAX

Taxable Year Ended December 31, 1948

Net income adjusted .....	\$309,863.94
Less: Exemptions .....	3,000.00
Balance, subject to surtax and normal tax.....	\$306,863.94
One-half of \$306,863.94 .....	\$153,431.97
Tentative surtax .....	\$110,305.81
Tentative normal tax at 3%.....	4,602.96
Total .....	\$114,908.77
Less reduction under Sec. 12(c), I.R.C. ....	13,473.61
Total normal tax and surtax on one-half of net income.....	\$101,435.16

Combined normal tax and surtax (\$101,435.16 x 2) ....	\$202,870.32
Combined alternative tax .....	\$201,309.08
Correct income tax liability.....	\$201,309.08
Income tax liability shown on return, account	
No. 3194309 .....	\$ 93,383.02
Deficiency of income tax .....	\$107,926.06

[Endorsed]: T.C.U.S. Filed Nov. 17, 1953.

[Title of Tax Court and Cause.]

### ANSWER

The Commissioner of Internal Revenue, by his attorney, Daniel A. Taylor, Chief Counsel, Internal Revenue Service, for answer to the petition of the above-named taxpayers, admits, denies and alleges as follows:

1. Admits that the petitioners are individuals, that they filed a return for the period herein involved. For lack of sufficient information, denies that petitioners reside at 66 Hampton Road, Piedmont, California; denies that the return for the period herein involved was filed with the Collector for the First Collection District of California.

2 and 3. Admits the allegations contained in paragraphs 2 and 3 of the petition.

4. Denies the allegations of error contained in paragraph 4 of the petition and all subparagraphs thereof.

5. Denies the allegations contained in paragraph 5 of the petition and all subparagraphs thereof.



6. Denies generally and specifically each and every allegation contained in the petition not heretofore expressly admitted, qualified or denied.

Wherefore, it is prayed that the determination of the Commissioner be approved.

/s/ DANIEL A. TAYLOR, REM  
Chief Counsel, Internal Revenue  
Service

Of Counsel:

Woolvin Patten, Acting Regional Counsel  
E. C. Crouter, Associate Appellate Counsel  
R. E. Maiden, Jr., Assistant Appellate Counsel  
John J. Burke, Special Attorney  
Internal Revenue Service

[Endorsed]: T.C.U.S. Filed Jan. 5, 1954.

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[Title of Tax Court and Cause.]

### STIPULATION OF FACTS

It Is Hereby Stipulated and Agreed by and between the parties hereto by their respective counsel of record that the following facts shall be taken as true without prejudice to the right of either party to submit material and competent evidence of any other facts not inconsistent herewith:

1. At all times herein material Petitioners, F. Norman Phelps and Alice Phelps, were husband and wife, residing in Piedmont, California. They filed a joint return for the calendar year 1948 with the Collector of Internal Revenue for the Sixth

Collection District of California. A copy of their federal income tax return for the year 1948 is attached hereto as Joint Exhibit 1-A.

2. At all times herein material Petitioners, Jackson Howell and Virginia Howell, were husband and wife, residing in Los Angeles County, California. They filed a joint return for the calendar year 1948 with the Collector of Internal Revenue for the Sixth Collection District of California. A copy of their federal income tax return for the year 1948 is attached hereto as Joint Exhibit 2-B.

3. At all times herein material the James A. Kenyon Trust was a trust created on August 8, 1941 by James A. Kenyon for the benefit of his adopted daughter, Patricia May Kenyon. A copy of the federal income tax return of said trust for the year 1948 is attached hereto as Joint Exhibit 3-C.

4. At all times herein material James A. Kenyon, the creator of said trust, was also the Trustee thereof.

5. The James A. Kenyon Trust is the same trust which is sometimes referred to as the Patricia May Kenyon Trust and/or Patricia Kenyon Pearson Trust. A copy of the document creating the James A. Kenyon Trust is attached hereto and made a part hereof as Joint Exhibit 4-D.

6. At all times herein material J. A. K. Co. was a corporation, all of whose stock was owned by James A. Kenyon, individually.

7. At all times herein material, Capitol Chevrolet Co. was a corporation duly organized and existing

under and by virtue of the laws of the State of California, with its principal place of business in Sacramento, California. Capitol Chevrolet Co. was incorporated on April 10, 1946 and at all times herein material it had but one class of stock outstanding. From the date of its incorporation to December 21, 1948 the ownership of all of its outstanding stock was as follows:

Shareholder	No. of Shares
F. Norman Phelps .....	212
Alice Phelps .....	213
James A. Kenyon, Trustee of Patricia May Kenyon Trust .....	170
J. A. K. Co.....	255

8. Howell Chevrolet Co. was incorporated on April 10, 1946 and at all times herein material it had but one class of stock outstanding. From the date of its incorporation to December 21, 1948 the ownership of all of its outstanding stock was as follows:

Shareholder	No. of Shares
Jackson Howell .....	300
F. Norman Phelps .....	150
Alice Phelps .....	150
James A. Kenyon, Trustee of Patricia May Kenyon Trust .....	120
J. A. K. Co. ....	180

9. Mid-Valley Chevrolet Co. was incorporated on April 10, 1946 and at all times herein material it had but one class of stock outstanding. From the date of its incorporation to December 21, 1948 the ownership of all of its outstanding stock was as follows:

Shareholder	No. of Shares
F. Norman Phelps .....	213
Alice Phelps .....	212
James A. Kenyon, Trustee of Patricia May Kenyon Trust .....	170
J. A. K. Co. ....	255

10. At all times herein material F. Norman Phelps, James A. Kenyon and Alice Phelps were President, Vice President and Secretary-Treasurer, respectively, of Capitol Chevrolet Co.

11. At all times herein material F. Norman Phelps, Joseph E. Carpenter and James A. Kenyon were President, Vice President and Secretary-Treasurer, respectively, of Mid-Valley Chevrolet Co.

12. At all times herein material Jackson Howell, F. Norman Phelps and James A. Kenyon were respectively President, Vice President and Secretary-Treasurer, of Howell Chevrolet Co.

13. On December 21, 1948, pursuant to resolutions adopted by the Board of Directors of Capitol Chevrolet Co. at a meeting held on said date, Capitol Chevrolet Co. distributed the following amounts of money to the following named shareholders in redemption of the following number of shares set forth beside their respective names, to wit:

Shareholder	Amt. Distributed	Shares Redeemed
F. Norman Phelps .....	\$ 37,759.15	65
Alice Phelps .....	37,759.15	65
Patricia May Kenyon Trust.....	75,518.30	130

A copy of the minutes of the meeting of the Board of Directors of Capitol Chevrolet Co. held on December 21, 1948 is attached hereto as Jt. Exh. 5-E.

14. On December 21, 1948, pursuant to resolutions adopted by the Board of Directors of Mid-Valley Chevrolet Co. at a meeting held on said date, Mid-Valley Chevrolet Co. distributed the following amounts of money to the following named shareholders in redemption of the following number of shares set forth beside their respective names, to wit:

Shareholder	Amt. Distributed	Shares Redeemed
F. Norman Phelps .....	\$ 37,170.25	65
Alice Phelps .....	37,170.25	65
Patricia May Kenyon Trust.....	74,340.50	130

A copy of the minutes of the meeting of the Board of Directors of Mid-Valley Chevrolet Co. held on December 21, 1948 is attached hereto as Joint Exhibit 6-F.

15. On December 21, 1948, pursuant to resolutions adopted by the Board of Directors of Howell Chevrolet Co. at a meeting held on said date, Howell Chevrolet Co. distributed the following amounts of money to the following named shareholders in redemption of the following number of shares set forth beside their respective names, to wit:

Shareholder	Amt. Distributed	Sharers Redeemed
F. Norman Phelps .....	\$ 23,254.00	50
Alice Phelps .....	23,254.00	50
Patricia May Kenyon Trust.....	46,508.00	100
Jackson Howell .....	46,508.00	100



A copy of the minutes of the meeting of the Board of Directors of Howell Chevrolet Co. held on December 21, 1948 is attached hereto as Joint Exhibit 7-G.

16. At the time of each of the foregoing distributions by Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. the accumulated earnings and profits of each of the said corporations was in excess of the total amount distributed to its shareholders.

17. Chevrolet Motor Division of General Motors Corporation had a policy that no interest in any Chevrolet dealership should be owned by a trust or by a holding company.

18. At no time from the date of incorporation of either Capitol Chevrolet Co., Mid-Valley Chevrolet Co. or Howell Chevrolet Co. to and including December 31, 1948 did any one of said corporations declare or pay a dividend to its shareholders.

19. At all times herein material each of the aforesaid corporations, to wit: Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. was engaged in the business of selling Chevrolet automobiles and each of said corporations operated under a separate "Annual Direct Dealer Selling Agreement" issued by the Chevrolet Motor Division of the General Motors Corporation.

20. On June 1, 1949 James A. Kenyon, as Trustee of the Patricia May Kenyon Trust, filed with the clerk of the Superior Court in and for the

County of Los Angeles, State of California, a petition for an order directing him to sell forty shares of stock of Capitol Chevrolet Co., forty shares of stock of Mid-Valley Chevrolet Co. and twenty shares of stock of Howell Chevrolet Co. then held by him as Trustee for the said Trust to the highest bidder at a sale to be conducted by an officer appointed by the Court and subject to such terms and conditions as the Court might direct. A copy of this petition is attached hereto as Joint Exhibit 8-H. Proceedings in this action were continued until July, 1950 when the need for the order prayed for in the petition disappeared by reason of the sales of the Trust stock mentioned in Paragraph 22 below and by reason of the complete liquidation of Mid-Valley Chevrolet Co. mentioned in Paragraph 23 below.

21. During the year 1950 and prior to July 26, 1950, J.A.K. Co. was completely liquidated and all of the stock held by it in each of the three corporations, to wit: Capitol Chevrolet Co., Mid-Valley Chevrolet Co., and Howell Chevrolet Co., were distributed to James A. Kenyon in his individual capacity.

22. On July 26, 1950, pursuant to resolutions adopted by the Boards of Directors of Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. in meetings held on that date:

(a) Capitol Chevrolet Co. purchased from James A. Kenyon, individually, the 255 shares of stock then owned by him in said corporation and pur-

chased from James A. Kenyon as Trustee of the James A. Kenyon Trust the forty shares of stock of that corporation then held by that Trust;

(b) Howell Chevrolet Co. purchased from James A. Kenyon, individually, the 180 shares of stock in that corporation then owned by him and purchased from James A. Kenyon, as Trustee of the James A. Kenyon Trust, the twenty shares of stock in said corporation then owned by that trust;

(c) Mid-Valley Chevrolet Co. purchased from F. Norman Phelps the 148 shares of stock in that corporation then owned by him; and

(d) Mid-Valley Chevrolet Co. purchased from Alice Phelps the 147 shares of stock in that corporation then owned by her.

23. On July 26, 1950, the Board of Directors of Mid-Valley Chevrolet Co. adopted a plan of complete liquidation of said corporation and thereafter, and prior to the close of the year 1950, the said Mid-Valley Chevrolet Co. was completely liquidated and dissolved and all of its assets transferred to its shareholders.

24. During the years 1948 and 1949 Jackson Howell received the following amounts of compensation for services rendered by him as President of Howell Chevrolet Co.:

1948 .....	\$50,690.89
1949 .....	\$48,752.25

25. Attached hereto and marked Joint Exhibits 9-I, 10-J, 11-K, 12-L and 13-M, respectively, are the

corporate income tax returns of the Howell Chevrolet Company for the taxable years 1946 to 1950, inclusive.

26. Attached hereto and marked Joint Exhibits 14-N, 15-O, 16-P, 17-R and 18-S, respectively, are the corporate income tax returns of the Mid-Valley Chevrolet Co. for the taxable years 1946 to 1950, inclusive.

27. Attached hereto and marked Joint Exhibits 19-T, 20-U, 21-V, 22-W and 23-X, respectively, are the corporate income tax returns of the Capitol Chevrolet Co. for the taxable years 1946 to 1950, inclusive.

28. At all times herein material J.A.K. Co. was a holding company with the shares of stock of Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. constituting substantially all of its assets.

29. The shares of stock redeemed by Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co., as set forth in Paragraphs 13, 14 and 15 hereof, were in each case cancelled by the respective corporations and their stated capital reduced accordingly.

30. Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. were corporations until 1944 when they were dissolved and liquidated and limited partnerships were substituted therefor. In 1946 these limited partnerships were dissolved and succeeded by corporations bearing the names of

the original corporations. The financial interests of the various individuals remained in substantially the same ratio throughout the transitions.

31. On May 2, 1955 petitioners F. Norman Phelps and Alice Phelps made a payment to the Director of Internal Revenue at Los Angeles, California, in the amount of \$107,926.00 with direction that \$107,900.00 of said amount be applied against the asserted deficiency which is the subject matter of the proceeding in Docket No. 51282 and \$26.06 be applied against interest, if any, accrued to that date. The said amount is held in the Director's suspense account.

/s/ WELLMAN P. THAYER,  
Counsel for Petitioners, F. Norman Phelps, Alice Phelps and James A. Kenyon Trust, James A. Kenyon, Trustee.

/s/ CAMERON B. AIKEN,  
Counsel for Petitioners, Jackson Howell and Virginia Howell.

/s/ JOHN POTTS BARNES, REM  
Chief Counsel, Internal Revenue Service, Counsel for Respondent.

[Endorsed]: T.C.U.S. Filed Sept. 12, 1955.



26 T. C. No. 105

Tax Court of the United States

Jackson Howell and Virginia Howell, Petitioners,  
vs. Commissioner of Internal Revenue, Re-  
spondent.

James A. Kenyon Trust, James A. Kenyon, Trus-  
tee, Petitioner, vs. Commissioner of Internal  
Revenue, Respondent.

F. Norman Phelps and Alice Phelps, Petitioners,  
vs. Commissioner of Internal Revenue, Re-  
spondent.

Docket Nos. 51216, 51265, 51282

Filed July 19, 1956

## FINDINGS OF FACT AND OPINION

Distributions in redemption of stock owned by a trust as a first step in an integrated plan to eliminate the trust as a stockholder held not to have been made at such time and in such manner as to be essentially equivalent to distributions of taxable dividends under Section 115(g), I.R.C. 1939. Cf. *Carter Tiffany*, 16 T.C. 1443. However, distributions to other stockholders in redemption of some of their shares in such manner as to leave them with the same fractional interests in the corporations held to be governed by Section 115(g). Cf. *James F. Boyle*, 14 T.C. 1382, affirmed, 187 F.2d 557 (C.A. 3).

Cameron B. Aiken, Esq., for the Petitioners in  
Docket No. 51216. Wellman P. Thayer, Esq., for

the petitioners in Docket Nos. 51265 and 51282. Mark Townsend, Esq., for the respondent.

The respondent determined the following deficiencies in the income taxes of petitioners:

	Year	Amount
Jackson Howell and Virginia Howell	1948	\$ 20,957.40
	1949	2,729.16
James A. Kenyon Trust, James A. Kenyon, Trustee .....	1948	96,057.27
F. Norman Phelps and Alice Phelps ....	1948	107,926.06

The question presented is whether distributions made by three corporations to the petitioners during 1948 in the redemption of a portion of their stock in such corporations were made at such time and in such manner as to be essentially equivalent to the distribution of taxable dividends.

In the case of petitioners Jackson Howell and Virginia Howell an issue raised with respect to the amount of compensation received by Jackson Howell from Howell Chevrolet Co. during the years 1948 and 1949 has been settled by stipulation.

### Findings of Fact

A portion of the facts have been stipulated; they are incorporated herein by reference as part of these findings.

Petitioners Jackson Howell and Virginia Howell, husband and wife, reside in Los Angeles County, California. They filed a joint return for the calendar year 1948 with the then collector of internal revenue for the sixth district of California.

The James A. Kenyon Trust was created on August 8, 1941, by James A. Kenyon for the benefit of his adopted daughter, Patricia May Kenyon. It is sometimes referred to as the Patricia May Kenyon Trust and/or Patricia Kenyon Pearson Trust. The trustee was its creator, James A. Kenyon (hereinafter referred to as Kenyon). It was irrevocable and Kenyon had no beneficial interest in the income or corpus thereof other than a remote reversionary interest. Kenyon, as trustee, was specifically given power in the trust instrument to deal with the property of the Trust as absolute owner including the power of sale.

Petitioners F. Norman Phelps (hereinafter referred to as Phelps) and Alice Phelps, husband and wife, reside in Piedmont, California. They filed a joint return for the calendar year 1948 with the then collector of internal revenue for the sixth district of California.

At all times material herein J. A. K. Co. was a corporation, all of the stock of which was owned by Kenyon, individually. It was a holding company with shares of stock of Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. constituting substantially all of its assets.

Capitol Chevrolet Co. was incorporated on April 10, 1946, and had but one class of stock outstanding. Phelps, Kenyon and Alice Phelps were President, Vice President and Secretary-Treasurer, respectively. From the date of its incorporation to December 21, 1948, the ownership of all of its outstanding stock was as follows:

Shareholder	No. of Shares
F. Norman Phelps .....	212
Alice Phelps .....	213
James A. Kenyon, Trustee of Patricia May Kenyon Trust .....	170
J. A. K. Co. ....	255

Howell Chevrolet Co. was incorporated on April 10, 1946, and had but one class of stock outstanding. Jackson Howell, Phelps and Kenyon were President, Vice President and Secretary-Treasurer, respectively. From the date of its incorporation to December 21, 1948, the ownership of all of its outstanding stock was as follows:

Shareholder	No. of Shares
Jackson Howell .....	300
F. Norman Phelps .....	150
Alice Phelps .....	150
James A. Kenyon, Trustee of Patricia May Kenyon Trust .....	120
J. A. K. Co. ....	180

Mid-Valley Chevrolet Co. was incorporated on April 10, 1946, and had but one class of stock outstanding. Phelps, Joseph E. Carpenter and Kenyon were President, Vice President and Secretary-Treasurer, respectively. From the date of its incorporation to December 21, 1948, the ownership of all of its outstanding stock was as follows:

Shareholder	No. of Shares
F. Norman Phelps .....	213
Alice Phelps .....	212
James A. Kenyon, Trustee of Patricia May Kenyon Trust .....	170
J. A. K. Co. ....	255

At all times herein material each of the cor-

porations, Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co., was engaged in the business of operating a Chevrolet dealership under a separate "Direct Dealer Selling Agreement" with the Chevrolet Motor Division of the General Motors Corporation (hereinafter referred to as Chevrolet). Each of these dealerships was located within the Pacific Coast Region.

From the year 1921 to April 10, 1946, petitioner Phelps was employed by Chevrolet, and during that period he occupied, successively, the positions of retail salesman, used car manager, sales manager, district manager, office manager, assistant zone manager, city sales manager, zone manager, assistant regional manager and regional manager for the Pacific Coast Region of Chevrolet.

Kenyon had practically the same background of experience with Chevrolet Motor Division of General Motors Corporation as Phelps.

From 1929 until 1933 Jackson Howell was employed by General Motors Acceptance Corporation, and from 1933 until 1944 he was employed by Chevrolet. During the latter period he occupied, successively, the offices of district manager, organization manager of Los Angeles, assistant zone manager of Los Angeles, branch manager in Great Falls, Montana, branch manager at Oakland, California, and assistant regional manager at Oakland, California.

The terms and conditions governing "all transactions, dealings and relations" between Chevrolet and each of its dealers are set forth in a written



agreement called a "Direct Dealer Selling Agreement". This agreement is in force for a period of one year ending on October 31st. Paragraph "Third" contains the names of the individuals who actively participate in the ownership and are responsible for the operation of the dealership. Paragraph 29 provides that either Chevrolet or the dealer may terminate the agreement by written notice of termination in the event that the other party violates or fails to comply with any of its terms or provisions, and also lists certain other causes which might result in its termination by Chevrolet. The last paragraph of the agreement states that "There are no other agreements or understandings, either oral or in writing, between the parties affecting this Agreement or relating to the sale or servicing of Chevrolet motor vehicles, chassis, parts or accessories."

On or about September 1, 1948, J. L. Connell, the Regional Manager of the Pacific Coast Region of Chevrolet, called Phelps to his office for a conference. Connell then informed Phelps that Chevrolet had established a new policy that no trust or holding company could own stock in a Chevrolet dealership, and that steps should be taken to eliminate the stock ownership of the James A. Kenyon Trust and J. A. K. Co. in the three corporations. Phelps assured Connell that he had been with Chevrolet long enough to know that when it requested them to take the trust and holding company out of the dealerships, this would have to be done, and they would comply with this request im-

mediately. At this conference Connell also suggested to Phelps that, because the operation of the dealerships had been mutually satisfactory, he felt that it would be more than fair that the Phelps, Kenyon, and Howell interests each retain, after meeting the new policy, the same per cent of ownership in the dealerships. In making this suggestion Connell was not "quoting" Chevrolet policy, and did not intend any implied threat whatsoever that if it were not followed a new selling agreement would not be issued. The only policy Chevrolet had with respect to stock ownership was that any person listed in paragraph "Third" of the Direct Dealer Selling Agreement must own outright a minimum of twenty-five per cent of the issued stock of the corporation.

Following his conference with Connell, Phelps got in touch with Kenyon and informed him of his conversation with Connell. Phelps suggested to Kenyon that he confer with Thomas E. Dempsey, attorney for the petitioners and for the three corporations, and have him work out some plan by which the requirements of Chevrolet could be met. Kenyon discussed the matter with Dempsey. In the course of their discussions the possibility of Kenyon personally purchasing all of the stock of the three corporations owned by the Trust was considered. This possibility was deemed not feasible because Kenyon did not have the money to make the purchase. Kenyon did not want the stock held by the Trust sold to someone other than himself because he was desirous of maintaining his relative

proportional voting interest and control in the dealerships. Kenyon and Dempsey also considered the possibility of eliminating the J. A. K. Co. ownership of stock by means of a liquidation. Dempsey recommended that this not be done during the year 1948 because it would cost about \$90,000 in taxes whereas if it were postponed until the Revenue Act of 1949 were passed the liquidation might be accomplished tax free.

After being advised of the attorney's recommendation against the liquidation of J. A. K. Co. in 1948, Phelps wrote the Zone Manager of Chevrolet at Oakland, California, on October 16, 1948, stating, among other things, the following:

\* \* \* \* \*

As you know, the J. A. K. Co., which is a Nevada corporation owned by James A. Kenyon, now owns 30 per cent of the stock in Capitol Chevrolet Company, 30 per cent in Mid-Valley Chevrolet, and 20 per cent in Howell Chevrolet. Our attorney advises that if this J. A. K. Co. were to be liquidated at the present time, the tax situation is such that Mr. Kenyon and I would be subject to approximately \$90,000 in tax.

It would seem that if it were possible for you to permit us to postpone the change until the Revenue Act of 1949 passes both the House and the Senate it would be most helpful to us.

\* \* \* \* \*

At the present time we are working on a way to buy out the Trust by the different corporations. We believe this can be handled because although it is

an irrevocable Trust, Mr. Kenyon has jurisdiction over the Trust until his daughter becomes of age.

\* \* \* \* \*

Because of the complications, I would appreciate Chevrolet Motor Division giving us six months or a year to work out of the seeming difficulties with which we are faced at the present time.

In addition to writing the foregoing letter Phelps also discussed the matter with Connell, the Regional Manager, and asked him whether or not it would be satisfactory if the liquidation of J. A. K. Co. were delayed until the new law was passed, and it was agreed by Connell that some extension would be given.

Pursuant to a prior agreement between Kenyon and Phelps, any tax liability which would result from the liquidation of J. A. K. Co. was to be shared between them. This company was not liquidated in 1948 because of the income tax liabilities that would result from such liquidation and the possibility that they would be reduced by new tax legislation in 1949.

On November 1, 1948, concurrently with the delivery to the three corporations of the new Direct Dealer Selling Agreements for the year commencing on that date, each of the corporations received two letters from Chevrolet. In one of these letters each corporation was notified that its operations were unsatisfactory in that all or a part of the ownership in the dealership was held by a trust and in the other that its operations were unsatisfac-



tory in that all or a part of the ownership in the dealership was held by a holding company. Each letter stated that "it is the desire and policy of Chevrolet Motor Division that all ownership of the Chevrolet dealership be held directly by individuals approved by Chevrolet Motor Division" and that the new Chevrolet Selling Agreement was being delivered "upon the express representation by you that action will be taken to effect the foregoing objective not later than" a specified date. The date specified for elimination of ownership of stock by the Trust was April 30, 1949, and by the holding company September 30, 1949. The probable consequence of failure to take the action required to satisfy the stock ownership policy would be that each corporation would receive a letter from Chevrolet stating that a new Selling Agreement would not be offered upon the expiration of the November 1, 1948 agreement because of noncompliance with its policy.

Dempsey formulated a plan for eliminating the trust as a stockholder of each corporation and it was presented at meetings of their boards of directors held in his office on December 21, 1948, and approved. The plan had two separate steps:

- (1) The purchase by each of the three corporations of a certain number of shares in such corporation from the trust, as well as the purchase by each of these corporations of a sufficient number of shares from the other stockholders (except J. A. K. Co.) so that the Phelps-Kenyon control in Capitol Chevrolet Co. and Mid-Valley Chevrolet Co.



would remain at 50 per cent each and the Phelps-Kenyon-Howell control in Howell Chevrolet Co. would remain at 33-1/3 per cent each; and

(2) The purchase by James A. Kenyon, personally, of the remaining shares owned by the Trust in each of the three corporations which were not to be purchased in Step (1).

The second step in the plan was expressly conditioned on the ability of Kenyon to secure the authorization of the Superior Court of the State of California of his purchase of the stock from the Trust; and, as an alternative to be used in the event the Court should fail to authorize such purchase, the plan provided that the three corporations would, respectively, purchase the remaining shares owned by the Trust and that Kenyon would purchase the same number of shares from the other stockholders of each corporation, in such manner as to preserve the same percentage of control.

At the meetings held on December 21, 1948, the directors of each corporation adopted the following resolution:

Whereas the purchase and redemption of stock according to the plan hereinabove set forth will reduce the corporation's working capital below its minimum requirements;

Now, Therefore, Be It Resolved that the officers of this corporation be and they hereby are authorized and directed to borrow, in behalf of this corporation, from such banks or trust companies as they may in their judgment determine, an amount not exceeding \$200,000, for such period of time and

upon such terms and rate of interest as may to them in their discretion seem advisable and to execute notes in respect thereto in the name of the corporation for the payment of the amount so borrowed.

Step (1) of the plan was executed on December 21, 1948, with the result that on that date the three corporations made distributions to stockholders in redemption of shares of stock, as follows:

Capitol Chevrolet Co.

Shareholder	Amt. Distributed	Shares Redeemed
F. Norman Phelps .....	\$ 37,759.15	65
Alice Phelps .....	37,759.15	65
Patricia May Kenyon Trust.....	75,518.30	130

Mid-Valley Chevrolet Co.

F. Norman Phelps .....	\$ 37,170.25	65
Alice Phelps .....	37,170.25	65
Patricia May Kenyon Trust.....	74,340.50	130

Howell Chevrolet Co.

F. Norman Phelps .....	\$ 23,254.00	50
Alice Phelps .....	23,254.00	50
Patricia May Kenyon Trust.....	46,508.00	100
Jackson Howell .....	46,508.00	100

Prior to December 21, 1948, Dempsey sent Phelps copies of proposed minutes of the directors' meetings which he had prepared. Before receiving these minutes Phelps was aware of the nature of the plan which was to be submitted to the directors, but its details had not theretofore been presented to him in writing. Howell was not present at the December 21, 1948 meeting of the directors of the Howell Chevrolet Company and had no knowledge of the

details of the plan until after it was adopted. Neither Phelps and his wife nor Howell needed the money distributed to them in redemption of their stock.

The shares of stock redeemed by the corporations were cancelled and the stated capital reduced accordingly. The operations of the corporations were not curtailed as a result of the redemptions, and they did not enter into any program of liquidation.

The stock ownership in Mid-Valley Chevrolet Co. and Capitol Chevrolet Co. immediately before and after the redemptions was as follows:

	Before—50%	After—50%
F. Norman Phelps	213 shares 25%	148 shares 25%
Alice Phelps	212 shares 25%	147 shares 25%
	Before—50%	After—50%
J. A. Kenyon, Trustee	170 shares 20%	40 shares 7%
J. A. Kenyon Company	255 shares 30%	255 shares 43%

The stock ownership in Howell Chevrolet Co. immediately before and after the redemptions was as follows:

	Before—33⅓%	After—33⅓%
F. Norman Phelps	150 shs. 16⅔%	100 shs. 16⅔%
Alice Phelps	150 shs. 16⅔%	100 shs. 16⅔%
	Before—33⅓%	After—33⅓%
J. A. Kenyon, Trustee	120 shs. 13⅓%	20 shs. 3⅓%
J. A. Kenyon Company	180 shs. 20%	180 shs. 30%
	Before—33⅓%	After—33⅓%
Jackson Howell	300 shs. 33⅓%	200 shs. 33⅓%

In the redemptions, the price paid per share in each of the corporations was as follows:

Mid-Valley Chevrolet Co.....	\$571.85
Capitol Chevrolet Co. ....	580.91
Howell Chevrolet Co. ....	465.08

The total amounts actually distributed by each corporation through the distributions in issue were as follows:

Mid-Valley Chevrolet Co. ....	\$148,681.00
Capitol Chevrolet Co. ....	151,036.60
Howell Chevrolet Co. ....	139,524.00

If the corporations had purchased all the shares of the trust without redeeming shares of the other stockholders, only the following amounts would have been required:

Mid-Valley Chevrolet Co. ....	\$97,214.50
Capitol Chevrolet Co. ....	98,747.70
Howell Chevrolet Co. ....	55,809.60

If only the shares of the trust had been redeemed by the three corporations, their capital would not have fallen below the capital standard requirements set by Chevrolet.

Because of the fact that the shares of other stockholders were redeemed along with the trust shares, the capital of the corporations fell below the standards set by Chevrolet. The additional cash distributions to the other stockholders placed a hardship on the corporations by requiring them to borrow funds. Failure to meet the capital standard requirements is reason for termination of a dealer's franchise.

The 1948 redemptions did not eliminate either the trust or the holding company as stockholders of the three corporations.

At the time of the 1948 distributions, the accumulated earnings and profits of each of the corporations were in excess of the total amount dis-



tributed to the shareholders. Earned surplus and undivided profits of each of the corporations as of December 31, 1948 after the distributions had been made, were as follows:

Mid-Valley Chevrolet Co. ....	\$275,536.12
Capitol Chevrolet Co. ....	285,666.90
Howell Chevrolet Co. ....	223,970.73

No dividends were ever declared or paid by any of the three corporations.

The consummation of Step (2) of the plan was commenced on June 1, 1949, by the filing by Kenyon, as Trustee of the Patricia May Kenyon Trust, of a petition to the Superior Court of the State of California, in and for the County of Los Angeles, for an order to sell the remaining trust stock in the three corporations to himself as an individual. Proceedings in this action were continued until July, 1950, when the need for the order prayed for in the petition disappeared by reason of the sales of the remaining Trust stock in Capitol Chevrolet Co. and Howell Chevrolet Co. to those corporations, respectively, and by the liquidation of Mid-Valley Chevrolet Co.

During the year 1950 and prior to July 26, 1950, J. A. K. Co. was completely liquidated and all of the stock held by it in each of the three corporations was distributed to Kenyon.

On July 26, 1950, Capitol Chevrolet Co. purchased from Kenyon the 255 shares of its stock then owned by him and also purchased from the Trust the 40 shares of its stock owned by the Trust. Howell Chevrolet Co. purchased from Kenyon the



180 shares of its stock then owned by him and also purchased from the Trust the 20 shares of its stock owned by the Trust; and Mid-Valley Chevrolet Co. purchased from Phelps the 148 shares of its stock then owned by him, and from Alice Phelps the 147 shares of its stock then owned by her. Thereafter during the year 1950 Mid-Valley Chevrolet Co. was completely liquidated and dissolved and all of its assets transferred to its stockholders.

Chevrolet did not object to the changes in the proportionate ownership and control of the three dealerships made during the year 1950.

The distributions to the trust in redemption of stock of the three corporations on December 21, 1948, were not made at such time and in such manner that they were essentially equivalent to distributions of taxable dividends.

The distributions to the other stockholders on December 21, 1948, were made at such time and in such manner that they were essentially equivalent to distributions of taxable dividends.

### Opinion

Raum, Judge: The distributions in this case resemble to a considerable extent those involved in *Carter Tiffany*, 16 T.C. 1443, and *James F. Boyle*, 14 T.C. 1382, affirmed, 187 F. 2d. 557 (C.A. 3), certiorari denied, 342 U.S. 817. Although the situations are not identical, they are sufficiently similar, in our judgment, to call for the same results.

We hold that the redemptions of the trust shares

did not constitute dividends under Section 115(g), Internal Revenue Code of 1939. Not only did these transactions sharply reduce the fractional interest of the trust in each of the corporations, but they represented a first step in an integrated plan to eliminate the trust completely as a stockholder. As to the trust, therefore, we think it plain that the distributions represented in substance as well as in form merely the purchase price for the shares, and not the payment of a taxable dividend. Cf. *Carter Tiffany*, *supra*; *Zenz vs. Quinlivan*, 213 F.2d 914 (C.A. 6).

However, as in the *Boyle* case, which presented other distributions by the same corporation involved in the *Carter Tiffany* case, we think that the distributions to the *Howell* and *Phelps* interests herein do fall within Section 115(g) as taxable dividends. The plan was so formulated and executed that the stockholders in question emerged with the identical fractional interests in the corporation which they had owned before; the distributions were not in partial liquidation of the corporations, and the operations of the businesses were in no way curtailed. In substance the distributions simply transferred to these stockholders accumulated earnings and profits of their corporations. It is no answer to say that these transactions had their origin in the demand of *Chevrolet* that the trust be eliminated as a stockholder. That objective could have been achieved, and indeed with less strain upon the corporations, merely by redeeming the shares of the trust. However, *Kenyon*

did not wish to have his control diluted, and Connell, the regional manager for Chevrolet, had himself suggested to Phelps that it would be fair to preserve the same ratios of control. But that suggestion did not represent Chevrolet policy, and we do not believe, on the evidence, that Phelps regarded it as such.<sup>1</sup> It was an objective that the parties themselves would undoubtedly have desired to attain, wholly apart from any suggestion emanating from Connell. Certainly, petitioners, who have the burden of proof, have not shown otherwise. The preservation of the same ratios of control, far from being a factor inconsistent with the application of Section 115(g), is in our judgment a consideration that tends rather to fortify the applicability of those provisions. For, in substance, the aim of the parties was to pay out corporate funds to stockholders in such manner that the distributions were in proportion to control and at the same time leave the distributees with the same fractional interests in the corporations. We find and hold that the distributions to the Phelps and Howell interests were made "at such time and in such manner as to make the distribution[s] \* \* \* essentially equivalent" to the distribution of taxable dividends. Section 115(g).

Decision will be entered under Rule 50 in Docket

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<sup>1</sup> In reaching this conclusion we do not rely upon the testimony given by Connell in his deposition, objected to by petitioners, that Phelps understood the suggestion as being his [Connell's] "rather than General Motor's suggestion or policy".

51216; decision for the petitioner in Docket 51265,  
and decision for the respondent in Docket 51282.

Served and Entered July 19, 1956.

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The Tax Court of the United States  
Washington

Docket No. 51282

F. NORMAN PHELPS and ALICE PHELPS,  
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

### DECISION

Pursuant to the determination of the Court, as  
set forth in its Findings of Fact and Opinion, filed  
July 19, 1956, it is

Ordered and Decided: That there is a deficiency  
in income tax for the year 1948 in the amount of  
\$107,926.06.

Entered: July 31, 1956.

[Seal]           /s/ ARNOLD RAUM,  
Judge

Served and Entered August 1, 1956.

In the United States Court of Appeals  
for the Ninth Circuit

Tax Court Docket No. 51282

F. NORMAN PHELPS and ALICE PHELPS,  
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

### PETITION FOR REVIEW

Taxpayers, the petitioners in this cause, by Wellman P. Thayer, counsel, hereby file their petition for a review by the Circuit Court of Appeals for the Ninth Circuit of the decision by The Tax Court of the United States rendered on July 31, 1956, 26 T.C. . ., No. 105, determining a deficiency in the petitioners' Federal income taxes for the calendar year 1948 in the amount of \$107,926.06 and respectively show:

#### I.

The petitioners, F. Norman Phelps and Alice Phelps, are husband and wife residing in Piedmont, California. They filed a joint return for the year 1948 with the Collector of Internal Revenue for the Sixth Collection District of California whose office was within the Ninth Judicial Circuit.

#### II.

##### Nature of the Controversy

The controversy involves the proper determina-



tion of the petitioners' joint liability for Federal income taxes for the calendar year 1948.

In the year 1948 petitioners were the owners of 50% of the outstanding capital stock of each of two corporations, Capitol Chevrolet Co. and Mid-Valley Chevrolet Co. The other 50% of the outstanding capital stock of each of said two corporations was owned in part by J. A. K. Co., a corporation and in part by the Patricia May Kenyon Trust. James A. Kenyon was the owner of all of the outstanding capital stock of J. A. K. Co. and was the trustee of the Patricia May Kenyon Trust. By reason of his ownership of all of the stock in J. A. K. Co. and his position as trustee of the Patricia May Kenyon Trust control of James A. Kenyon over the affairs of each of said two corporations was equal to the control of petitioners over the affairs of such two corporations.

In the year 1948 petitioners were the owners of one-third of the outstanding capital stock of Howell Chevrolet Co. One-third of the stock of that corporation was owned by Jackson Howell and the remaining one-third was owned in part by J. A. K. Co. and in part by the Patricia May Kenyon Trust. By reason of his ownership of all of the stock in J. A. K. Co. and his position as trustee of the Patricia May Kenyon Trust the control of James A. Kenyon over the affairs of Howell Chevrolet Co. was equal to the control of petitioners and said Howell over the affairs of that corporation.

Capitol Chevrolet Co., Mill-Valley Chevrolet Co. and Howell Chevrolet Co. were each engaged in the

business of operating a Chevrolet dealership under a separate agreement with Chevrolet Motor Division of General Motors Corporation.

In the year 1948 Chevrolet Motor Division of General Motors Corporation adopted a new policy to the effect that no trust could own any stock in a dealership corporation and in that year demand was made upon each of the above named corporations that the Patricia May Kenyon Trust be removed from the ownership of stock in each of the three corporations.

The adoption of this new policy by Chevrolet Motor Division was brought to the attention of the three corporations by C. F. Connell, the Regional Sales Manager of Chevrolet Motor Division having jurisdiction over the three corporations. Mr. Connell, acting in his official capacity as Regional Sales Manager, advised petitioner F. Norman Phelps, in his capacity as an officer of the three corporations, that the demand of Chevrolet Motor Division would have to be complied with and suggested that the removal of the trust from ownership of stock in the three corporations be accomplished in such a manner that the proportionate controls of petitioners and Kenyon in Capitol Chevrolet Co. and Mid-Valley Chevrolet Co. and the proportionate controls of petitioners, Kenyon and Howell in Howell Chevrolet Co. be not disturbed.

On December 21, 1948, as the first step in compliance with Chevrolet Motor Division's demand that the Patricia May Kenyon Trust be removed from ownership of stock in the three corporations

and in compliance with the suggestion of the Regional Manager that such removal be accomplished in such a manner as to leave the proportionate control of James A. Kenyon in each of the three companies undisturbed, Capitol Chevrolet Co. and Mid-Valley Chevrolet Co. each purchased and redeemed 130 of the shares owned by the Patricia May Kenyon Trust and a like number of shares owned by petitioners, and Howell Chevrolet Co. redeemed 100 of the Trust shares and a like number of shares owned by petitioners and Jackson Howell.

Capitol Chevrolet Co. paid petitioners the sum of \$75,518.30 for the shares which were so purchased and redeemed by it, Mid-Valley Chevrolet Co. paid petitioners the sum of \$74,340.50 for the shares which were so purchased and redeemed by it and Howell Chevrolet Co. paid petitioners the sum of \$46,508.00 for the shares which were so purchased and redeemed by it.

On their joint return for the year 1948 petitioners reported the amount so received by them from each of the three corporations as an amount received upon the sale of shares in such corporation and paid tax thereon accordingly.

The Commissioner of Internal Revenue determined that the amount received by petitioners from each of the said three corporations constituted an ordinary dividend.

### III.

Petitioners, being aggrieved by the Findings of Fact and Conclusions of Law contained in the Findings and Opinion of the Court and by its Decision

entered pursuant thereto, desire to obtain a review thereof by the United States Court of Appeals for the Ninth Circuit.

#### IV.

##### Assignments of Error

Petitioners assign as error the following acts and omissions of The Tax Court of the United States:

1. The finding that the distributions made by the three corporations, Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co., to petitioners on December 21, 1948 were made at such time and in such manner as to be essentially equivalent to distributions of taxable dividends.

2. The finding that there is a deficiency in petitioners' Federal income taxes for the year 1948 in the amount of \$107,926.06.

3. The finding that the redemptions of the stock made by the three corporations, Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co., on December 21, 1948 caused the capital of said corporations to fall below the standards set by Chevrolet Motor Division of General Motors Corporation.

4. The failure to find that the redemption of petitioners' stock in each of the three corporations, Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co., on December 21, 1948 was not made at such a time or in such a manner as to be substantially equivalent to a taxable dividend.

5. The failure to find that the amount received by petitioners from each of the three corporations,

Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co., in the year 1948 constituted an amount received in exchange for such corporations' shares.

/s/ W. P. THAYER,

Counsel for Petitioners

Duly Verified.

[Endorsed]: T.C.U.S. Filed October 25, 1956.

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[Title of U. S. Court of Appeals and Cause.]

### NOTICE OF FILING

To John P. Barnes, Esq., Chief Counsel, Bureau of Internal Revenue, Washington, D. C.

You are hereby notified that the petitioners on the 25th day of October 1956 filed with the Clerk of The Tax Court of the United States at Washington, D. C., a Petition for Review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of The Tax Court of the United States heretofore rendered in the above entitled cause.

A copy of the Petition for Review and the Assignment of Error as filed is hereto attached and served upon you.

Dated: October 25, 1956.

DEMPSEY, THAYER, DEIBERT  
& KUMLER,

By WELLMAN P. THAYER,

Attorneys for the Petitioners

Acknowledgment of Service attached.

[Endorsed]: T.C.U.S. Filed October 31, 1956.



[Title of Tax Court and Cause.]

### CERTIFICATE

I, Howard P. Locke, Clerk of The Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 14, inclusive, constitute and are all of the original papers on file in my office as called for by the "Designation of Contents of Record on Review", and the "Designation of Additional Portions of Record", including exhibits 1-A through 23-X attached to the stipulation of facts and exhibit 24 attached to the deposition of F. Norman Phelps, in the case before the Tax Court of the United States docketed at the above number and in which the petitioners in the Tax Court have initiated an appeal as above numbered and entitled, together with a true copy of the docket entries in said Tax Court case, as the same appear in the official docket book in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 20th day of November, 1956.

[Seal]            /s/ HOWARD P. LOCKE,  
Clerk Tax Court of the United  
States

[Title of Tax Court and Cause.]

### STIPULATION TO TAKE DEPOSITION

It Is Hereby Stipulated and Agreed by and between the parties hereto by their respective counsel of record that the testimony of F. Norman Phelps, a witness on the part of the petitioners, whose address is 66 Hampton Road, Piedmont, California, be taken at 9:00 a.m. o'clock on August 11, 1955 at 1104 Pacific Mutual Building, 523 West 6th Street, Los Angeles 14, California, before Helen D. Wilson, a notary public in and for the County of Los Angeles, State of California, and that if said deposition is not completed on said day it will be continued from time to time thereafter until completed; that said deposition and testimony, when taken, may be read and used in evidence in said cause on any trial thereof or in any proceeding therein, subject to the same objections and exceptions as if said witness were personally present, but without objection or exception to the time, place and manner of taking the same, or to the form of the questions, unless noted at the time.

/s/ WELLMAN P. THAYER,  
Counsel for Petitioners, F. Norman Phelps, Alice Phelps and James A. Kenyon Trust, James A. Kenyon, Trustee.

/s/ CAMERON B. AIKENS,  
Counsel for Petitioners, Jackson Howell and Virginia Howell.

/s/ JOHN POTTS BARNES, REM  
Chief Counsel, Internal Revenue Service, Counsel  
for Respondent.

[Title of Tax Court and Cause.]

## DEPOSITION OF F. NORMAN PHELPS

Room 1104, Pacific Mutual Building, 523 West  
Sixth Street, Los Angeles 14, California, Thursday,  
August 11, 1955.

### Testimony for Petitioners

The parties met, pursuant to Stipulation, at 9:00  
a.m. at the above time and place.

Present: Wellman P. Thayer, Esq., of Dempsey,  
Thayer, Deibert & Kumler, 523 West Sixth Street,  
Los Angeles 14, California, for Petitioners F. Nor-  
man Phelps and Alice Phelps and the James A.  
Kenyon Trust. Cameron B. Aikens, Esq., of Getz,  
Aikens & Manning, 6435 Wilshire Boulevard, Los  
Angeles 48, California, for Petitioners Jackson  
Howell and Virginia Howell. Mark Townsend, Esq.,  
(Hon. John Potts Barnes, Esq., Chief Counsel, In-  
ternal Revenue Service) 1135 Subway Terminal  
Building, Los Angeles, California, for the Com-  
missioner. [2\*]

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\* Page numbers appearing at top of page of original Reporter's  
Transcript of Record.

Proceedings

F. NORMAN PHELPS

called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

Direct Examination

Q. (By Mr. Thayer): Will you state your name, please?      A. F. Norman Phelps.

Q. Are you one of the petitioners in this proceeding?      A. I am.

Q. What is your occupation?

A. At the present time I am President of Capitol Chevrolet Co. in Sacramento.

Q. What is Capitol Chevrolet Co.? What is its business?

A. It has a franchise from Chevrolet Motor Division to sell Chevrolet cars at retail.

Q. What was your occupation during the year 1948?

A. I was President of Capitol Chevrolet Co. I was President of Mid-Valley Chevrolet Co., and Vice President of Howell Chevrolet Co.

Q. Have you ever been employed by Chevrolet Motor Division of General Motors Corporation?

A. Yes. [4]

Q. During what period were you employed by Chevrolet Motor Division?

A. Since 1921 to 1946.

Q. What were your duties during your period of employment?

A. Retail salesman, used car manager for Chev-

(Deposition of F. Norman Phelps.)

rolet Motor Division, Sales Manager, District Manager, Office Manager, car distributor, Assistant Zone Manager, City Sales Manager, Zone Manager, Assistant Regional Manager, and Regional Manager of the Pacific Coast Region until 1946.

Q. What area did the Pacific Coast Region cover?

A. The Pacific Coast Region covered the West Coast. It covers the State of Washington, the State of Oregon, the State of California, the State of Idaho, the State of Nevada, the State of Utah, part of Montana, part of Wyoming, and part of Arizona. That comprises the Pacific Coast Region.

Q. What are the duties of a Regional Manager of Chevrolet Motor Division?

A. The duties of Regional Manager of Chevrolet Motor Division are to carry out directives from the central office, hold meetings with zone managers, set policies, develop programs for the benefit of Chevrolet Motor Division and its dealer organizations.

Q. During the period in which you were Regional Manager for the Pacific Coast Region, what was the chain of command [5] within the Sales Department of Chevrolet Motor Division from the General Sales Manager to the dealer?

A. The chain of command would be in Chevrolet Motor Division from the General Manager to the General Sales Manager, from the General Sales Manager to Assistant General Sales Manager in the Eastern half of the United States and the Western half of the United States. Then from the Assistant



(Deposition of F. Norman Phelps.)

General Sales Manager to the Regional Managers in the nation. Does that answer your question?

Q. During the period in which you were Regional Manager, did you ever have occasion to relay directives from the General Sales Manager to the various dealers?

A. Many times. Yes, I did.

Q. What procedure did you follow in relaying such directives?

A. You usually would work through the Zone Manager. Sometimes you would handle the directive directly with the dealer, but in the majority of the instances it would be handled through the regular procedure which would be Zone Manager, Assistant Zone Manager, District Manager to dealers.

Q. Do you remember whether in the year 1948 that same procedure was in effect?

A. It was.

Q. During the year 1948 within what Division was the dealership known as Capitol Chevrolet Co., within what [6] region?

A. Pacific Coast Region.

Q. And within what zone?

A. It is Oakland Zone.

Q. And within what region and zones were the Mid-Valley and Howell Chevrolet Co.?

A. Mid-Valley and Howell were in the Pacific Coast Region and in an area known as the Los Angeles Zone.

Q. The three, then, were within the Western Region?

A. In the Pacific Coast Region.

(Deposition of F. Norman Phelps.)

Q. In 1948 who was in charge of the Pacific Coast Region?      A. J. L. Connell.

Q. During the year 1948 who was the Zone Manager of the Oakland Zone?

A. A. W. Strang.

Q. During the year 1948, who was the Zone Manager of the Los Angeles Zone?

A. Joe Steele.

Q. Was Mr. Steele the Zone Manager during the entire year?

A. No. Mr. Culbertson was the early part of the year, and Mr. Steele the latter part of the year.

Q. Mr. Phelps, I show you a document entitled "Direct Dealer Selling Agreement, Chevrolet Motor Division, General [7] Motors Corporation," and will ask you if the signature of F. Norman Phelps appearing thereon is your own?      A. It is.

Q. What is the nature of that document?

A. Well, this is a selling agreement that is given to the dealer which enables him to handle the ensuing year.

Q. And the date of the document?

A. Date November 1, 1948.

Q. And what period would that selling agreement cover?

A. It would be from November 1 of 1948 to November 1, or a few days one way or the other, of 1949, because they are not always given at a certain date.

Mr. Thayer: I now offer this document in evidence as Petitioners' Exhibit No. 24.

Mr. Townsend: May I ask a preliminary ques-

(Deposition of F. Norman Phelps.)

tion here? This was the contract that was in effect from the period 1948 to 1949?

The Witness: That is right.

Mr. Townsend: No objection.

(The document above referred to was marked Petitioners' Exhibit No. 24 for identification and received in evidence.)

[See pages 110-133.]

Q. (By Mr. Thayer): On or about November 1, 1948, did you execute a similar agreement on behalf of Mid-Valley Chevrolet Co.?

A. I did.

Q. On or about November 1, 1948 did you execute a similar document on behalf of Howell Chevrolet Co.? [8] A. I did.

Q. Were the documents which you executed on behalf of Mid-Valley Chevrolet Co. and Howell Chevrolet Co. identical in all respects with Petitioners' Exhibit No. 24? A. They were.

Q. In all respects?

A. In all respects with the exception of perhaps the documents were the same, but the signatures and maybe Paragraph 3 was different.

Q. You say "maybe Paragraph 3." Would you look at Paragraph 3 and tell me whether that would have been changed in the other two?

A. This is Capitol. That is of Norman Phelps and James A. Kenyon. In Howell it would be Jackson Howell, F. Norman Phelps, James A. Kenyon. In Mid-Valley it would be F. Norman Phelps, James A. Kenyon and Joe Carpenter.

Q. I hand you a photostatic copy of a letter

(Deposition of F. Norman Phelps.)

dated November 1, 1948 addressed to Capitol Chevrolet Co. and signed by A. W. Strang, Zone Manager. I will ask you if that document was received by Capitol Chevrolet on or about the date it bears?

A. It was.

Q. And was that document related in any manner to Petitioners' Exhibit No. 24, the Direct Dealer Selling Agreement? [9]

A. It was part of it.

Mr. Thayer: I now offer this in evidence as Petitioners' Exhibit No. 25.

Mr. Townsend: May I ask what is the purpose of the offering?

Mr. Thayer: The two documents taken together and a third document, which will follow, constitute the total agreement between Chevrolet Motor Division and the dealer.

Mr. Townsend: No objection.

(The document above referred to was marked Petitioners' Exhibit No. 25 for identification and received in evidence.)

[See page 133.]

Q. (By Mr. Thayer): Referring to Petitioners' Exhibit No. 25, Mr. Phelps, I call your attention to the first paragraph which states as follows: "Please take notice that the Capital Standard Agreement dated 8-15-47 heretofore executed by you shall continue in full force and effect and shall constitute a part of the new Chevrolet Selling Agreement entered into with you on that date provided——" I hand you the photostatic copy of a document entitled General Motors Dealer's Capital

(Deposition of F. Norman Phelps.)

Standard Program, Capital Standard Agreement with Capitol Chevrolet Co., and will ask you if this is the same Capital Standard Agreement dated August 15, 1947 which is referred to in Petitioners' Exhibit 25?      A. It is.

Mr. Thayer: I now offer this in evidence as Petitioners' Exhibit No. 26. [10]

Mr. Townsend: No objection.

(The document above referred to was marked Petitioners' Exhibit No. 26 for identification and was received in evidence.)

[See pages 136-141.]

Q. (By Mr. Thayer): Do you know of your own knowledge whether or not, during the year 1948, Mid-Valley Chevrolet Co. and Howell Chevrolet Co. were parties to similar Capital Standard Agreements with Chevrolet Motor Divisions?

A. They were.

Q. And were the printed portions of the Mid-Valley and Howell Capital Standard Agreements identical with the printed portions of Petitioners' Exhibit 26?      A. They were.

Q. I show you a photostatic copy of a letter from Chevrolet Motor Division addressed to Capitol Chevrolet Co. dated November 1, 1948 signed by A. W. Strang, Zone Manager, and will ask you if Capitol Chevrolet Co. received that letter on or about the date it bears?

A. I received this letter.

Mr. Townsend: May I see that?

Mr. Thayer: That is the first of six letters. I



(Deposition of F. Norman Phelps.)

offer this letter in evidence as Petitioners' Exhibit 27.

Mr. Townsend: May I ask the purpose of this offer?

Mr. Thayer: The purpose of the offer is to [11] establish the reason for the action later taken during the year 1948 by Capitol Chevrolet Co. to remove the Patricia May Kenyon Trust from ownership of stock in this corporation.

Mr. Townsend: It is not offered to prove the facts contained in the letter, then?

Mr. Thayer: It is not offered to prove any fact contained within the letter.

Mr. Townsend: No objection.

(The document above referred to was marked Petitioners' Exhibit No. 27 for identification and was received in evidence.)

[See page 143.]

Q. (By Mr. Thayer): I show you another letter from Chevrolet Motor Division to Capitol Chevrolet Co. dated November 1, 1948 signed by A. W. Strang and will ask you if Capitol Chevrolet Co. received that letter on or about the date it bears?

A. I did.

Mr. Thayer: I offer this letter in evidence.

Mr. Townsend: Not offered to prove the facts therein?

Mr. Thayer: It is Petitioners' Exhibit No. 28.

(The document above referred to was marked Petitioners' Exhibit No. 28 for identification and was received in evidence.)

[See page 144.]

(Deposition of F. Norman Phelps.)

Q. (By Mr. Thayer): I show you a photostatic copy of a letter from [12] Chevrolet Motor Division addressed to Mid-Valley Chevrolet Co. dated November 1, 1948 signed by J. W. Steele, Zone Manager, and will ask you if Mid-Valley Chevrolet Co. received that letter on or about the date it bears?

A. They did.

Mr. Thayer: I offer this letter in evidence as Petitioners' Exhibit No. 29.

Mr. Townsend: That is the Trust?

Mr. Thayer: That is the Trust, Mid-Valley.

Mr. Townsend: Offered for the same purpose?

Mr. Thayer: Yes.

Mr. Townsend: No objection.

(The document above referred to was marked Petitioners' Exhibit No. 29 for identification and was received in evidence.)

[See page 146.]

Q. (By Mr. Thayer): I show you a letter from Chevrolet Motor Division addressed to Mid-Valley Chevrolet Co. dated November 1, 1948 and signed by J. W. Steele, Zone Manager, and will ask you if Mid-Valley Chevrolet Co. received this letter on or about the date it bears.

A. They did.

Mr. Thayer: I offer this letter in evidence as Petitioners' Exhibit No. 30.

Mr. Townsend: For the same purpose? [13]

Mr. Thayer: Same purpose.

Mr. Townsend: No objection.

(Deposition of F. Norman Phelps.)

(The document above referred to was marked Petitioners' Exhibit No. 30 for identification and was received in evidence.)

[See page 148.]

Q. (By Mr. Thayer): I show you a letter from Chevrolet Motor Division to Howell Chevrolet Co. dated November 1, 1948 signed by J. W. Steele, Zone Manager, and will ask you if that letter was received by Howell Chevrolet Co. on or about the date it bears? A. It was.

Mr. Thayer: I offer this in evidence as Petitioners' Exhibit 31.

Mr. Townsend: Same purpose?

Mr. Thayer: Same purpose.

Mr. Townsend: No objection.

(The document above referred to was marked Petitioners' Exhibit No. 31 for identification and was received in evidence.)

[See page 150.]

Q. (By Mr. Thayer): I show you a letter from Chevrolet Motor Division addressed to Howell Chevrolet Co. dated November 1, 1948 and signed by J. W. Steele, Zone Manager, and will ask you if this letter was received by Howell Chevrolet Co. on or about the date it bears? [14]

A. It was.

Mr. Thayer: I offer this letter in evidence as Petitioners' Exhibit No. 32.

Mr. Townsend: Same purpose?

Mr. Thayer: Same purpose.

Mr. Townsend: No objection.

(Deposition of F. Norman Phelps.)

(The document above referred to was marked Petitioners' Exhibit No. 32 for identification and was received in evidence.)

[See page 152.]

Q. (By Mr. Thayer): Mr. Phelps, referring to Petitioners' Exhibits Nos. 27 through 32, both inclusive, will you please relate the circumstances under which those letters were received by the three corporations named therein?

A. Well, they were just—they were received saying that they wanted to get the Trust out. Then they wanted to get the holding company out.

Q. Were they received by the corporations concurrently with the delivery to the corporations of the new dealership agreements?

A. No. As I remember, they talked to me about this before.

Q. Well, referring to the letters themselves. In each of them the opening paragraph begins as follows: "In delivering to you herewith new Chevrolet Selling Agreement to be [15] effective for the term commencing November 1, 1948,"——

A. What I mean to say is that when you sign the contract, they talk to you about certain things, so they talked to me about this and whether it came that day or the next day, I really don't remember; but we got it at the time, but I knew about it at the time we signed the contract. Does that answer your question?

Q. Well, I wish to find out whether or not these letters were delivered to the companies concur-

(Deposition of F. Norman Phelps.)

rently with the delivery of the selling agreements.

A. Oh, yes.

Q. Referring again to the first paragraph of each of these letters which states in full as follows in the case of Petitioners' Exhibit No. 32, "In delivering to you herewith new Chevrolet Selling Agreement to be effective for the term commencing November 1, 1948, we direct your attention to the fact that our action is not to be regarded as evidence of satisfaction on our part with the operation of your dealership as to financial set-up within the requirements of Paragraph 15 thereof. On the contrary, your operation is unsatisfactory in that all or part of the ownership of the dealership is held in effect by a holding company."

I also call your attention to the first paragraph of Petitioners' Exhibit No. 31 which is identical with the last quoted paragraph except for the final words in the sentence [16] referring to the fact that a part of the ownership of the dealership is held by a trust and will ask you if these letters constituted the first notice which these companies had had of dissatisfaction on the part of Chevrolet Motor Division of the operation of the companies because of the fact that a part of the stock of each of the companies was held by a Trust and by a holding company?

A. They were not the first. I had a call from Mr. Connell, Regional Manager of Chevrolet Motor Division. He asked me to come to his office, which I did, and he informed me of a new policy Chevrolet Motor Division had in which they would not



(Deposition of F. Norman Phelps.)

allow any trust or any holding company to have any part of a Chevrolet franchise. He informed me at that time that steps should be taken by us to eliminate the Trust and the holding company.

He further stated that we should leave the stockholdings in exactly the same proportion as they were. I informed Mr. Connell that I had been with Chevrolet long enough to know that if they requested that we take the holding company and the Trust out of the Chevrolet dealerships that they meant it, and we would do so immediately.

Q. Do you remember the approximate date of your first conversations with Mr. Connell on this subject?

A. I would say—no, I don't. It was approximately two months before we got the letter, I would say. [17]

Q. I show you a photostatic copy of what purports to be a carbon copy of a letter addressed to Mr. Gus Culbertson, Chevrolet Motor Division, Los Angeles, California, bearing a typed signature of F. Norman Phelps and will ask you where the carbon copy of this letter was found.

A. This is in my file.

Q. Do you recall writing that letter?

A. Yes, I do.

Q. Did you mail that letter to Mr. Culbertson?

A. Yes. It is the same type of letter that I sent to Mr. Strang.

Q. I offer this letter in evidence as Petitioners' Exhibit No. 33.

Mr. Townsend: No objection.

(Deposition of F. Norman Phelps.)

(The document above referred to was marked Petitioners' Exhibit No. 33 and received in evidence.)

[See page 153.]

Mr. Thayer: I show you a photostatic copy of what purports to be a carbon copy of a letter addressed to Mr. A. W. Strang, Chevrolet Motor Division, dated September 18, 1948 bearing the typed signature of F. Norman Phelps and will ask you where the carbon copy of that letter was found.

The Witness: This is the same letter. It was found in my files.

Q. (By Mr. Thayer): Do you recall writing this letter? [18]           A. I did.

Q. And did you mail the letter to Mr. Strang?

A. I did.

Mr. Thayer: I offer this letter in evidence as Petitioners' Exhibit No. 34.

Mr. Townsend: No objection.

(The document above referred to was marked Petitioners' Exhibit No. 34 and received in evidence.)

[See page 154.]

Q. (By Mr. Thayer): I show you a photostatic copy of what purports to be a carbon copy of a letter addressed to Mr. A. W. Strang dated October 16, 1948 and bearing the typed signature of F. Norman Phelps and will ask you where the carbon copy of this letter was found.           A. In my files.

Q. Do you recall writing the letter?

A. I do.

Q. And did you mail the letter?

(Deposition of F. Norman Phelps.)

A. I did.

Mr. Thayer: I offer this letter in evidence as Petitioners' Exhibit No. 35.

Mr. Townsend: The purpose for offering these letters is not to prove the facts stated therein, but that Mr. Phelps mailed these letters?

Mr. Thayer: That Mr. Phelps did take the action [19] indicated by these letters.

Mr. Townsend: No objection.

(The document referred to was marked Petitioners' Exhibit No. 35 and received in evidence.)

[See page 155.]

Q. (By Mr. Thayer): Referring to Petitioners' Exhibits Nos. 33, 34, and 35, I will ask you if these letters were written by you as the result of your conversation with Mr. Connell?

A. Mr. Connell. Also, Mr. Strang sent Mr. DeLong up to see me, and asked what we were going to do and how we were going to get the Trust and the holding company out. Note one of these letters refers to Mr. DeLong's visit.

Q. And did these letters reflect your intentions at the time? A. They did.

Q. Following your conversation with Mr. Connell, what steps did you take to comply with the wishes expressed by him in that conversation?

A. I got in touch with Mr. Kenyon who handled the financial end of our business who was located here in Los Angeles. Then I got in touch with Mr. Dempsey who was our attorney. Does that answer your question?

(Deposition of F. Norman Phelps.)

Q. Will you identify the Mr. Dempsey that you referred to, please?

A. Mr. Dempsey was our attorney, the senior partner of [20] Dempsey, Thayer, Deibert & Kumler.

Q. Mr. Thomas R. Dempsey? A. Yes.

Q. In your discussions with Mr. Kenyon concerning the manner in which you could comply with General Motor's wishes, as expressed by Mr. Connell, did you discuss various ways and means of complying with those wishes?

A. I told Mr. Kenyon that Mr. Connell informed me as to what we had to do, and I told Mr. Kenyon I thought that he should get in touch with Mr. Tom Dempsey and work out some plan that we could comply with. There were many plans that Mr. Dempsey came up with, but finally the only plan that was feasible was the one that we adopted.

Mr. Townsend: Respondent moves to strike the last part of that answer as a conclusion.

Q. (By Mr. Thayer): In your conversations with Mr. Kenyon, concerning the various methods by which General Motor's wishes as presented by Mr. Connell could be complied with, did you and Mr. Kenyon discuss the possibility of Mr. Kenyon personally purchasing all of the stock of the Trust and all of the stock of the holding company owned by the Trust and the holding company in each of these corporations?

A. I talked with Mr. Dempsey on that——

Mr. Townsend: Respondent objects. I believe

(Deposition of F. Norman Phelps.)

the [21] witness is about to go into hearsay testimony, and I object for that reason.

Mr. Thayer: Will you repeat the question?

(The question was read by the reporter.)

Mr. Townsend: Same objection.

Q. (By Mr. Thayer): Will you answer the question? A. Yes.

Q. Your answer is yes?

A. Yes, we discussed it, but nothing was formulated as far as we were concerned. That was all handled with the attorney. We discussed many plans as to how we could comply and what we would have to do to comply.

Q. Do you know of your own knowledge whether or not in the fall of 1948 Mr. Kenyon had sufficient funds to purchase all of the stock of the three corporations which were owned by his Trust and by the Patricia May Kenyon Trust and by his holding company?

Mr. Townsend: Respondent objects to the form of the question. That is leading.

The Witness: I know he didn't have the money. That was one of the things that we discussed over a period of many times and things he discussed with Mr. Dempsey. That was one of the reasons why we were so worried about the thing, because we couldn't comply with it immediately; with what Chevrolet [22] Motor Company wanted, because Mr. Kenyon didn't have the money to do it.

Q. (By Mr. Thayer): Is Mr. Thomas R. Dempsey still alive?

A. No. He died some time ago.



(Deposition of F. Norman Phelps.)

Q. Was a plan finally adopted by the three corporations to accomplish the removal of the Patricia May Kenyon Trust from the ownership of the stock in those corporations? A. It was.

Q. Were you aware of the nature of this plan before its adoption? A. I was.

Q. How did you learn of the details of the plan?

A. When Mr. Dempsey sent me the Minutes and also talked to me on the telephone.

Q. Do you know of your own knowledge who devised the plan which was finally adopted?

A. Mr. Dempsey.

Q. Was this plan at any time presented to you in writing other than in the Minutes of the proposed meetings of the Boards of Directors of the three corporations? A. It was not.

Q. Did the plan which was adopted by the Boards of Directors of the three corporations on December 21, 1948 result in all of the stock owned by the Trust being redeemed by [23] each of the three corporations?

A. Practically all. There was some small amount that was not redeemed. There was some difficulty that the attorney and Kenyon had but which did practically what Chevrolet Motor Company requested.

Q. Do you know what steps were proposed to be taken to eliminate the ownership by the Trust of the shares which were not redeemed by the corporations? A. No, I don't.

Q. My Phelps, do you know why the corpora-

(Deposition of F. Norman Phelps.)

tions did not redeem all of the stock owned by the Trust?

Mr. Townsend: Respondent objects. The proper foundation has not been laid for that question. I believe it may well call for hearsay testimony.

Q. (By Mr. Thayer): You have testified that you were President of Capitol Chevrolet Co., President of Mid-Valley Chevrolet Co. and Vice President of Howell Chevrolet Co., I believe?

A. That is right.

Q. Were you familiar with the financial status of each of those companies? A. I was.

Q. In December of 1948? A. I was.

Q. Do you know of your own knowledge whether these [24] three corporations were capable of redeeming all of the shares of stock owned by the Trust in each of the three corporations?

A. Would you repeat that again?

Q. Do you know of your own knowledge whether each of these corporations was financially capable of redeeming all of the stock of the Trust owned by the Trust in each of the three corporations?

A. I would have to look at the financial statements. I can't tell you that unless I see it.

Mr. Townsend: I may say that I think the record might speak for itself on that in that we have the corporate returns showing the surplus on those various dates, and we also have stipulated the number of shares held by the Trust, the amounts that were distributed to all the people in this redemption.

Mr. Aikens: On behalf of Howell Chevrolet I

(Deposition of F. Norman Phelps.)

object to statements made by counsel for the reason he is only taking into consideration only some of the factors that had to be considered by the shareholders and the corporate counsel in determining the course that was followed, and I particularly refer to the capital requirements established by the Chevrolet Motor Division.

Q. (By Mr. Thayer): I show you the balance sheet which is a part of [25] the corporate income tax return of Capitol Chevrolet Co. for the year 1948 and will ask you if that balance sheet reflects all of the matters which would have been reflected on the General Motor's-type balance sheet for the month of December, 1948?

A. May I ask a question?

Q. Yes.

A. On line 17, earned surplus, is this the same surplus as we have in the General Motors? Does this include everything? I have never seen this before. Does this include everything that we have on ours in our financial statements?

Q. As far as the surplus itself is concerned?

A. Yes.

Q. That reflects all of the information which is reflected on the General Motors form?

A. To the best of my knowledge, yes.

Q. Mr. Phelps, you have testified that the corporations did not redeem all of the stock owned by the Trust. You have also testified that Mr. Connell told you that General Motors required that the Trust be removed completely from these corporations. Did not your failure to redeem all of the

(Deposition of F. Norman Phelps.)

Trust stock constitute a violation of the requirements set forth by Mr. Connell and by the letters which are in evidence as Petitioners' Exhibits 27 through 32, both inclusive?

A. I don't think so. I think that we showed good [26] faith, and we tried to take out the Trust and the holding company and do everything that Chevrolet wanted, but there was just a small amount that I knew nothing about which was between Mr. Kenyon and Mr. Dempsey that they would take it out as soon as they possibly could; but we did everything Chevrolet asked us to do as far as we could, I understand.

Q. Did not the failure of the three companies to remove the holding company from ownership in their stock constitute a violation of the requirements of Chevrolet?

A. No. There was some new law coming out that Mr. Dempsey talked about and that they were waiting on, and I talked to Mr. Connell and asked him whether or not it would be satisfactory if we could wait until this thing would happen, because it would cost an awful lot of money to do the things that they required at the present time; and I asked for an extension, and I also wrote a letter on that.

Q. At any time during the period which you were the Regional Manager of Chevrolet Motor Division for the Pacific Coast Region, did you ever have occasion to make a request or a suggestion to a dealer under you concerning the operation of his dealership?      A. Many times.

Q. Based upon your experience as an employee



(Deposition of F. Norman Phelps.)

of Chevrolet Motor Division, particularly upon your experience during the time in which you were the Regional Manager for [27] the Pacific Coast Region, did you have a belief on November 1, 1948, as to the consequences to the three dealerships, Capitol Chevrolet Co., Mid-Valley Chevrolet Co., and Howell Chevrolet Co., of their failure to comply with the request that the Trust and the holding company be removed from ownership of the stock in those corporations?

A. Do you want my experience as Regional Manager or as a dealer? You tell me which one you want, and I will be very happy——

Mr. Townsend: Respondent objects to that question as calling for a conclusion and calling for the opinion of the witness based on a hypothetical question which he is not qualified to answer.

The Witness: I am qualified to answer that one; if I have ever been qualified, I am qualified to answer that one. I know this: That any time that Chevrolet Motor Division requested a dealer to do anything, they had better do it or they will not have a new franchise, regardless of anybody else, the Government or anybody else, I know that and that is the only reason we did it.

Q. (By Mr. Thayer): Based upon your experience as an employee of the Chevrolet Motor Division, particularly your experience as Regional Manager of the Pacific Coast Region, did you have a belief in 1948 as to the consequences to the three [28] dealerships, Capitol Chevrolet Co., Mid-Valley Chevrolet Co., and Howell Chevrolet Co., of their



(Deposition of F. Norman Phelps.)

failure to comply with the suggestion of Mr. J. L. Connell that the Trust and holding company be removed from ownership of stock in such dealerships in such a manner as not to disturb the then existing proportionate control of yourself and Mr. Kenyon in those corporations?

Mr. Townsend: Would you just answer that yes or no, Mr. Phelps?

The Witness: Yes, I did.

Q. (By Mr. Thayer): What was your belief?

Mr. Townsend: Respondent objects to the question as calling for a conclusion. Further, it is a hypothetical question which assumes facts that are not in the record, facts which are disputed, and facts which are yet to be proved.

It has been called to respondent's attention that Mr. Phelps testified that Mr. Connell told him that the proportionate ownership should remain the same. If respondent did not object to that testimony, he does so now on the basis that it is hearsay testimony.

The Witness: My belief was that over a period of years that when Chevrolet makes a suggestion that you comply with that suggestion, and I assumed that Mr. Connell wanted to leave everything exactly the same as it was, because we were going along pretty well on an equal basis, Mr. Kenyon and myself particularly; and as far as any dealer doing other than what Chevrolet wants them to do, they just don't do it.

Q. (By Mr. Thayer): What was your belief as

(Deposition of F. Norman Phelps.)

to the effect upon the dealerships of their failure to comply with these suggestions?

A. It was my firm belief that unless we complied with Chevrolet's demands and requests that either our franchise would not be renewed next year or our franchise would have been cancelled, because we were going against a direct policy of theirs. That is the only reason we did it.

Q. Did you have that belief in 1948?

A. Yes.

Q. In December, 1948, did you have any need for the money which you received from Capitol Chevrolet Co., Mid-Valley Chevrolet Co., and Howell Chevrolet Co. upon the redemption by those companies of a portion of your stock?

A. Did I have any need for it? No particular need, no.

Q. Do you know of your own knowledge whether or not Mrs. Phelps had any need for the money received by her?           A. She did not.

Q. In your discussions with Mr. Dempsey concerning the plan to remove the Trust and the holding company from the dealerships, did you ever request that the plan be so drawn [30] that you would receive any cash or property out of the corporations or any of them?

A. I did not.

Q. Did you at any time suggest to Mr. Dempsey that it would be a desirable feature of any plan which might be devised by him that you and Mrs. Phelps, or either of you, receive any cash or property from any of the corporations?

(Deposition of F. Norman Phelps.)

A. I did not.

Q. I show you a photostatic copy of an agreement dated December 21, 1948 between F. Norman Phelps, Alice Phelps, James A. Kenyon, Jackson Howell, and James A. Kenyon, Trustees of the Patricia May Kenyon Trust, and will ask you if it is your signature which appears thereon?

A. It is.

Q. I offer this in evidence as Petitioners' Exhibit No. 36.

Mr. Townsend: No objection.

(The document referred to was marked Petitioners' Exhibit No. 36 and received in evidence.)

[See page 157.]

Q. (By Mr. Thayer): Referring to Petitioners' Exhibit 36, Mr. Phelps, which is the agreement concerning the purchase by James A. Kenyon of the remaining Trust shares in Howell Chevrolet Company, I will ask you whether or not on or about the 21st day of December, 1948 similar agreements were entered into [31] concerning the purchase by Mr. Kenyon of the remaining Trust stock in Mid-Valley Chevrolet Co. and Capitol Chevrolet Co.

A. They were.

Q. (By Mr. Aikens): Are you a university graduate, Mr. Phelps?      A. I am.

Q. When did you graduate from the university, or what university?

A. University of Michigan in 1920.

Q. And when did you first commence your em-

(Deposition of F. Norman Phelps.)

ployment with the Chevrolet Motor Division, or whatever that corporation was then known as?

A. It was Chevrolet Motor Division in 1921.

Q. And since 1921 until to date, as I understand your testimony, you have consistently worked for the Chevrolet Motor Division or Chevrolet dealers or as a dealer?

A. That is right.

Q. Were you ever at any time offered any position with the Chevrolet Motor Division superior to that of the Regional Manager?

A. I was many times.

Q. And what position, or positions, have you been offered by Chevrolet?

A. Assistant General Sales Manager for the Western [32] half of the United States.

Q. And when were you first offered that position, approximately?      A. 1943.

Q. Subsequent offers were made to you of the same position after that by Chevrolet?

A. They were.

Q. I call your attention to Petitioners' Exhibit No. 31 which purports to be a letter written on the letterhead of Chevrolet Motor Division dated November 1, 1948 addressed to Howell Chevrolet purporting to have been signed by a J. W. Steele, Zone Manager, and call your attention particularly to the lower left-hand corner thereof and the words, "The foregoing is hereby agreed to and accepted this 1st day of November, 1948, Howell Chevrolet, By——" Is that your signature?      A. It is.

Q. Were you requested or were you not re-

(Deposition of F. Norman Phelps.)

quested by Chevrolet Motor Division to sign that letter agreement consisting of Petitioners' Exhibit 31?      A. I was.

Q. I call your attention to Petitioners' Exhibit 32, likewise calling your attention to the lower left-hand corner of that exhibit and to the same words referred to that I have mentioned as being contained in Exhibit 31 and ask you whether or not the Chevrolet Motor Division or some representative of [33] that Division asked that you sign that letter agreement on behalf of Howell Chevrolet Co.?      A. Yes.

Q. I show you now what purports to be a photostatic copy of the Minutes of the Meeting of the Board of Directors of Howell Chevrolet held December 21, 1948 and identified here as Joint Exhibit 7-G, and I would like, Mr. Phelps, for you to look at that and read it.

(The Minutes were read by the witness.)

The Witness: Yes, I remember this.

Q. (By Mr. Aikens): Do those Minutes fairly reflect the facts as you understood them to be respecting Howell Chevrolet at the time of the meeting of December 21, 1948?

A. That was the meeting at which Mr. Dempsey and Mr. Kenyon got together on the method that could be devised so that we could comply with Chevrolet Motor's request.

Q. You were the President of the corporation at that time, were you?      A. Vice-President.

Q. Do the facts as therein related fairly reflect



(Deposition of F. Norman Phelps.)

the facts as you knew them at that time respecting Howell Chevrolet Co.?

A. As I knew them, yes.

Q. Where was that meeting held? [34]

A. As I recall, I think it was held in Mr. Dempsey's office, right in this office.

Q. Was Mr. Howell personally present at that time? A. No, he was not present.

Q. Was he consulted respecting the action that was taken at that meeting prior to the meeting?

A. I don't know. He might have been.

Q. Do you have any recollection of whether you ever told Mr. Howell of the action that was to be taken at the December 21, 1948 meeting of the Board of Directors of Howell Chevrolet Co.?

A. I don't remember whether I did or not. It wouldn't have made any difference, because we had to do it anyway.

Q. I take it that Mr. Kenyon and you controlled the Board, and you felt it was immaterial one way or the other whether you consulted Mr. Howell before the action was taken?

A. Not a bit. We didn't control it at all. We each owned one-third of it. It was just a case of something we had to do for Chevrolet Motor Division. The only reason Mr. Kenyon knew about it was because he handled that with Mr. Dempsey, and he was down here handling the financial end of the business.

Q. During your long experiences with the Chevrolet Motor Division, either as you worked up the ladder of success with Chevrolet Motor Division

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or as an employee of a [35] Chevrolet dealership or subsequently as a Chevrolet dealer, have you ever known, of your own knowledge, of any dealer selling agreements having been cancelled or not renewed for the failure on the part of a Chevrolet dealer to comply with a suggestion or a request made to that dealer by the Chevrolet Motor Division?

A. Yes, but I would like to say that there are very few dealers that want to argue to Chevrolet Motor Division. If Chevrolet Motor Division asks them to do certain things, they usually do them, Mr. Aikens.

Q. If they do not do them, what happens?

A. Well, something happens, and there are very few of them that want to take that chance. In other words, on your Capital Standard Agreement, you have to have so much money in there, and it says in the Capital Standard Agreement that unless you keep that amount there, you are subject to cancellation for cause and no one wants to fight the General Motors Corporation. Does that answer your question?

Q. Thank you. Based upon your long experience with the Chevrolet Motor Division and particularly your interest in Howell Chevrolet and generally to the other corporations, did you, after receipt of letters delivered to you addressed to Howell Chevrolet in particular and, as I understand it, the two other corporations, Mid-Valley and Capitol, set any time within which the Trusts were to be extin-

(Deposition of F. Norman Phelps.)

guished or [36] retired from the dealership as well as the holding company?

A. Did we set any time? Is that your question?

Q. After a time was set within which they were to be done, and I refer you again to Petitioners' Exhibits 31 and 32 each addressed to Howell Chevrolet Co., and I call your attention particularly to Paragraphs 1 through 3 thereof, did you feel that there was a necessity to comply with the terms of this letter agreement? A. I certainly did.

Q. And I refer now to the two letters addressed to Howell Chevrolet, Petitioners' Exhibits 31 and 32. A. Yes.

Q. With respect to the similar letters almost identically worded that were received by Mid-Valley Chevrolet and Capitol Chevrolet, did you feel likewise that there was a necessity that the terms of that agreement be complied with?

A. I certainly did.

Q. You have referred previously to one or more conversations with Mr. Connell, then Regional Manager, respecting the desire of Chevrolet to have the holding company and the Trust withdrawn from any participation in these three corporations and the balance of control with respect to you and Mr. Kenyon in some of those dealerships and you and Mr. Kenyon and Howell Chevrolet Co., and having had that conversation with Mr. Connell, did you feel that it was necessary [37] that his suggestions be followed? A. I certainly did.

Q. Was it his suggestion that the balance of power, and I use that broadly speaking, remain the

(Deposition of F. Norman Phelps.)

same throughout the three dealerships as they previously existed?

Mr. Townsend: Respondent objects to the question as calling for hearsay.

Mr. Aikens: I will withdraw the question and reword it.

Q. (By Mr. Aikens): Did anyone from the Chevrolet Motor Division suggest that the balance of power remain the same after the retirement of the holding company and the Trust company?

Mr. Townsend: Same objection.

The Witness: Mr. Connell, in stating that the Chevrolet Motor Division would not allow a holding company or a Trust to have any part of a Chevrolet franchise, also said that when we made that change he would suggest that there would be no change in the proportionate amounts of stock held by each person.

Q. (By Mr. Aikens): Based upon your long experience associated with, and indeed executive of, Chevrolet Motor Division, what is the word "suggested" by Chevrolet synonymous with insofar as a dealer is concerned? [38]

A. Things of importance, any suggestions complied with as far as the dealer is concerned.

Q. Can you, based upon extensive experience, give me any synonyms that you think mean the same thing from your experience with the word "suggestion" or "request" as it relates to a request or a suggestion from the Chevrolet Motor Division to a dealer?

A. I don't know about a synonym, but it is hard



(Deposition of F. Norman Phelps.)

to explain. If Chevrolet Motor Division suggests that you do something, the dealer assumes that they want it done, and they do it. They just do not want to take any chances. That's the whole thing. I don't think it is a command or anything of the kind, but the dealer takes it as such.

Q. Did you feel, and I refer now to the time or the interim from the time Mr. Connell first talked to you about that matter up to and through the time that the actions were taken by the various Boards of Directors of Howell Chevrolet, Mid-Valley Chevrolet, and Capitol Chevrolet, all approximately on December 21, 1948, that if you failed or refused to comply with the suggestion that the interest of the Trust be extinguished, that the selling agreements were in jeopardy?

A. We weren't certain, but we didn't feel we should take any chances.

Q. Did you feel that the selling agreements were in jeopardy if you flatly refused? [39]

A. I personally did.

Q. Or failed to comply with the suggestion?

A. Yes.

Q. Did you feel that the selling agreements were in jeopardy if you failed or refused flatly to maintain the balance of control that Mr. Connell had suggested?

A. I felt that it was just as important, because it was all said in the same breath that they would not allow this and in taking out the Trust and in taking out the holding company that you leave the



(Deposition of F. Norman Phelps.)

proportionate shares the same. I took it as one package.

Q. Based upon your extensive experience, and I ask now for an expert opinion, do you feel that Jackson Howell alone could have maintained that franchise if you and Mr. Kenyon had decided to get out and leave Jackson Howell alone in there at that time in 1948? A. No.

Q. Did you ever personally discuss with Mr. Kenyon his buying all of the interest of the Trust and J. A. K. Co. from the various dealerships?

A. We might have discussed it, but not seriously. He handled that with Mr. Dempsey, our attorney.

Q. Were you or were you not intimately familiar with Mr. Kenyon's financial circumstances at that time?

A. I would say I knew quite a bit about them, yes. [40]

Q. At that time you were in a position pretty well to ascertain his net worth?

A. I would say so.

Q. And the liquidity of his assets?

A. I don't know about the liquidity of his assets, no, not all of them, because I didn't know what they were.

Q. When this problem of balance of control and the extinguishments of the Trust and the extinguishment of the holding company's interest in the various dealerships was raised, did you at any time ever ask Mr. Kenyon to step up and buy out

(Deposition of F. Norman Phelps.)

the Trust or buy out the holding company so that he individually could hold it all?

A. I did not. The only thing I told him was what Chevrolet Motor Division told me.

Q. While you have been a Chevrolet dealer, Mr. Phelps, if the Regional Manager were to tell you that he suggested that you avoid wearing red ties, would you be inclined to wear red ties?

A. I don't think the Regional Manager would say that in the first place.

Q. Assume that the Regional Manager told you that he did not like to have his dealers wear red ties, would you be inclined to wear red ties in his presence? A. Yes, I think I would.

Q. Were you or were you not at any time advised by Mr. [41] Thomas R. Dempsey, now deceased, that the monies received on the contracts of these various corporations would be handled by you or received by you and given long-term capital gain treatment?

A. They certainly were.

Q. What did Mr. Dempsey say in that connection to you?

Mr. Townsend: Respondent objects to the question as calling for hearsay.

Mr. Aikens: Withdrawn. Mr. Phelps, I have withdrawn the last question. However, if you have anything to say in response to it, would you say it now?

The Witness: I don't know whether it has any bearing, but I didn't want to do it on that basis, because I was worried about the Capital Standard

(Deposition of F. Norman Phelps.)

Agreements. I remember talking to Mr. Dempsey about how much it was going to cost, and he said I could take it on a long-term capital gain, and he said he had found out, and in two days' time he called me in Sacramento, and told me that it was perfectly satisfactory to do it, because it could be done on a long-term capital gains basis and it would be 25 per cent instead of ordinary income; because at that time we were making quite a lot of money and I didn't want the thing done that way; and that is the way he said. That is the only way he could do it to comply with Chevrolet's request.

Q. Did you and Mr. Howell ever at any time from the [42] commencement of Howell Chevrolet and until December 21, 1948, have any conversations relating to the fact, if it be a fact, that he preferred to own more of the company?

A. Who?

Q. That Mr. Howell would prefer to own more of the company.      A. No.

Q. Did he, during that period of time, at any time indicate to you that the third, third, and third was an unsatisfactory arrangement as far as he was concerned?      A. Not that I recall.

Mr. Thayer: Just one question to clear up the record. A few moments ago I asked you the following question, "Based upon your experience as an employee of Chevrolet Motor Division, particularly upon your experience during the time in which you were the Regional Manager, did you have a belief on November 1, 1948 as to the consequences to the three dealerships, Capitol Chevrolet Co., Mid-Val-

(Deposition of F. Norman Phelps.)

ley Chevrolet Co., and Howell Chevrolet Co., of their failure to comply with the request that the Trust and the holding company be removed from ownership of the stock in those corporations?

Following the asking of that question, Mr. Townsend interposed an objection, and following his objection and without directly answering the question, you stated, "I know this: That at any time that Chevrolet Motor Division [43] requested a dealer to do anything, they had better do it or they will not have a new franchise, regardless of anybody else, the Government or anybody else, I know that, and that is the only reason we did it."

Was the answer which I have just quoted a statement of your belief as to the effect upon the corporation of your failure to comply?

The Witness: It was.

Mr. Aikens: I have, I think, two more questions, if I may.

Q. (By Mr. Aikens): You have related your background, Mr. Phelps, indicating virtually your mature life you have been in the automobile business associated directly or indirectly with Chevrolet? A. That's right.

Q. Could you tell us if you know the background, briefly, of Mr. Kenyon as it relates to his association, directly or indirectly, with Chevrolet?

A. Practically the same as mine.

Q. And with respect to Jackson Howell, could you tell us just generally and very briefly respecting his experience with Chevrolet?

A. It was with the corporation. The only differ-

(Deposition of F. Norman Phelps.)

ence between his and Mr. Kenyon's and my own was that he was with [44] General Motors Acceptance Corporation for a good number of years and came with Chevrolet Motor Division in 1933.

Q. Assuming that upon your failure and refusal to comply with Chevrolet's request respecting any one or all three of these dealerships, and a termination had resulted, could you tell us, based upon your extensive experience with Chevrolet, would any other Chevrolet dealership franchise have been available to you or offered to you or the corporations?

A. They would not, or any other General Motors franchise would not have been offered to us.

Q. Did you know of any other automotive franchises that were available to you, and when I say "you" I mean these three corporations, in 1948 or 1949 had the unfortunate event of termination by Chevrolet occurred?

A. Did I know of any? No.

Q. I have no further questions.

#### Cross Examination

Q. (By Mr. Townsend): At the time of the stock reduction in 1948, Mr. Phelps, was it your intention that the business continue as it did before, the business of the three corporations continue as it did before? A. Yes.

Q. Did the corporations contract any of their business [45] or curtail any of their operations after this redemption? A. Not that I recall.

Q. The resolutions providing for the redemp-



(Deposition of F. Norman Phelps.)

tion, specifically Exhibits 5-E, 6-F, and 7-G, attached to Stipulation of Facts, state that the redemption will reduce the corporations' working capital below their minimum requirements and therefore authorize the officers to borrow on behalf of the corporations. What do you mean by minimum requirements?

A. The minimum requirements as set up by Chevrolet Motor Division.

Q. And that is with respect to working capital?

A. Working capital.

Q. Did the officers actually borrow money on behalf of the corporation in accordance with this authority?

A. I don't recall. I think we did at times.

Q. In your direct testimony, Mr. Phelps, you stated that Joe Carpenter was one of the named parties in the contract between General Motors and Capitol, which is similar to Exhibit 24 between General Motors and Mid-Valley. I beg your pardon. He was one of the named parties in Paragraph 3 of the contract between General Motors and Mid-Valley.

A. I might have said he was. Joe Carpenter was the operator in Mid-Valley. I was certain that he was on Paragraph 3. However, all we have to do is look at it and we can [46] tell whether he is or not.

Q. Mr. Carpenter owned stock for a while in Capitol, but his stock was reassigned, was it not?

A. You mean his stock in Mid-Valley?

Q. Yes, I beg your pardon.

A. I really don't recall.

(Deposition of F. Norman Phelps.)

Q. You don't recall anything about Carpenter's stock?

A. No, I don't recall what the particulars of it were.

Q. Well, any of the background or anything about his having some and then not having some?

A. I don't recall it.

Q. Now, you also stated on your direct testimony, I believe, that when the plan was formulated by Mr. Dempsey, it was sent to you along with the copy of the Minutes, is that correct?

A. That is correct. The plan was in the Minutes.

Q. The plan was in the Minutes. In other words, you got a copy of the Minutes before your corporate meetings were actually held?

A. No. We didn't. We did have a meeting, and we did decide, and it was there, the record of it as to what we were going to do and how it could be done for the best of everyone in complying with Chevrolet Motor Company's request. Does that answer your question?

Q. The Minutes I refer to, Mr. Phelps, adopt the plan [47] which you eventually followed through. The letters refer to a fact that a plan had been informally agreed upon, which I assume was at a prior date.

A. I think that is the one we talked about to Mr. Dempsey on the telephone.

Q. But at this particular meeting you adopted the plan itself, as formulated by Mr. Dempsey?

A. That is right.

(Deposition of F. Norman Phelps.)

Q. And these Minutes were also, I believe you stated, prepared when the plan was formulated? That is what I am having a little difficulty following.

A. We had a meeting here, and we talked about the different plans. They finally decided on one plan. Then we came down here, and we had the meeting and adopted that plan as the one that would be feasible to comply with Chevrolet Motor Company's request.

Q. And were the three corporation meetings held at the same time? A. Yes.

Q. And they were held in Mr. Dempsey's office?

A. Yes, right in this office.

Q. Were these Minutes typed up prior to the meeting or after the meeting?

A. After the meeting.

Q. They were typed up here in Mr. Dempsey's office? [48]

A. I don't know about that, where they were typed up, but I imagine so.

Q. You also spoke about a delay in eliminating the holding company, the J. A. K. Company, and the reason was that a new law was coming out. Was the law you were speaking about the income tax revisions which were then planned?

A. I really don't know anything about the law. The only thing that I told Chevrolet Motors Division was that we couldn't comply with that request, and I asked for six months' time to do something about it, because my attorney, Mr. Dempsey, said there was some new law that was going to come

(Deposition of F. Norman Phelps.)

out. We could comply with their request and it wouldn't cost quite as much money as if we did it right now.

Q. Money in what way?

A. Taxes or something.

Q. Directing your attention to Exhibit 35, Mr. Phelps, which is a letter sent by you to Mr. Strang and dated October 16, 1948, and particularly the third paragraph thereof which reads as follows: "As you know, the J. A. K. Co., which is a Nevada corporation, owned by James A. Kenyon, now owns 30 per cent of the stock in Capitol Chevrolet Co., 30 per cent in Mid-Valley Chevrolet, and 20 per cent in Howell Chevrolet. Our attorney advises that if this J. A. K. Co. were to be liquidated at the present time, the tax situation is such that Mr. Kenyon and I would be subject to approximately [49] ninety thousand dollars taxes."

In Paragraph 4, "It would seem that if it is possible for you to permit us to postpone the change until the Revenue Act of 1949 passes both the House and the Senate, it would be most helpful to us."

How would the liquidation of the J. A. K. Co., which was wholly owned by Mr. Kenyon, result in you being subject to tax?

A. I have no idea. That was a letter I wrote to Mr. Strang. I don't know. I might have miswritten it there or something. It wouldn't have any——

Q. Why didn't the J. A. K. Co., which was wholly owned by Mr. Kenyon, distribute its stock to Mr. Kenyon and thus comply with the General

(Deposition of F. Norman Phelps.)

Motor's requirement respecting the holding companies?

A. I have no idea. I don't know anything about that. It was up to Mr. Dempsey, our attorney, to handle that.

Q. And I believe you stated that Mr. Kenyon did not purchase all the stock of the Trust, because he didn't have the financial ability to do so?

A. There was something on that that Mr. Dempsey and he handled. There was some reason why he did not purchase it. I really don't know the answer to that, but I thought we had complied with the majority of Chevrolet's request, and we had shown our fair intentions, and we were doing what they wanted [50] us to do.

Q. I believe you also testified that you knew of Mr. Kenyon's financial situation, net worth at about the time of this distribution. Is that correct?

A. I said I knew approximately his net worth, yes. I also said I didn't know exactly how liquid it was.

Q. You don't know or do you have any idea of how much money he had on hand?

A. I might have at the time but I don't remember what it was.

Q. Did you ever discuss with him how much money he had, whether he had enough money to purchase this stock?

A. I remember he said he didn't have enough money to purchase it.

Q. Didn't General Motors deal with you and Mr. Kenyon on a personal basis regardless of your



(Deposition of F. Norman Phelps.)

stock ownership? A. What do you mean?

Q. Well, I direct your attention to Exhibit 24 which is the Direct Dealer Selling Agreement between General Motors and Capitol Chevrolet Co. and Paragraph Third thereof which lists F. Norman Phelps and James A. Kenyon, and it goes on to state that the individual, or individuals, designated shall be responsible for any act or omission of any dealers' agents or employees which may be contrary to the purposes and objectives of this agreement or the obligations of the dealer under—[51] and so on. Does that not indicate that General Motors dealt with you and Mr. Kenyon on an individual basis, regardless of the stock ownership?

A. Yes, it does.

Q. As a matter of fact, Mr. Kenyon didn't own any stock in his own name at all, did he?

A. Did he own any?

Q. I mean J. A. K. Co. and the Trust.

A. Well, he owned the Trust and he owned the stock. He owned the company that owned it.

Q. Your wife owned stock at the time that you entered into this contract, did she not?

A. Yes.

Q. Why was not her name added in Paragraph Third thereof?

A. Because she would not operate the deal, attend the meetings and do all the things that were absolutely necessary to do.

Q. And Mrs. Phelps also owned stock in Mid-Valley and Howell Chevrolet Co.?

A. That is right.

(Deposition of F. Norman Phelps.)

Q. She was not named in Paragraph Third of the contracts either.

A. Only because she was not the actual operator. Just the actual operators of the business were on Paragraph Third. [52]

Q. So that regardless of the stock ownership, General Motors looked to you and Mr. Kenyon as the active management and as the individuals responsible to keep the provisions of this contract?

A. Chevrolet Motor Division held Mr. Kenyon and myself responsible for Capitol Chevrolet. They held Mr. Carpenter and Mr. Kenyon and Mr. Phelps responsible for Mid-Valley Chevrolet. They held Mr. Kenyon, Mr. Howell and Mr. Phelps responsible for Howell Chevrolet.

Q. After these corporations were liquidated in 1950, Mr. Phelps, you were still associated with Capitol Chevrolet Co.?      A. Yes.

Q. And you continued the management of that corporation?      A. I did.

Q. Were you the sole stockholder of that corporation, you and your wife?      A. Yes.

Q. And after that liquidation in 1950, do you know, of your own knowledge, whether the Mid-Valley Automobile Agency continued?

A. It did. It continued as a dealership.

Q. Did Mr. Kenyon continue in the active management of Mid-Valley? [53]

A. I think so.

Q. With respect to Howell Chevrolet, after the date of liquidation in 1950, did Mr. Howell continue the active management of Howell Chevrolet?

(Deposition of F. Norman Phelps.)

A. He did.

Q. Did you ever independently suggest to the General Motor's officials that the ownership of these corporations should remain the same in view of their successful management?

A. No, I did not.

Q. That is enough for me.

### Redirect Examination

Q. (By Mr. Thayer): You stated, I believe, that you think that the three corporations probably borrowed money after the redemption of the stock in question, and it is my recollection of your statement that the reason for it, you said, was that it was necessary to maintain your capital standard requirement. Does borrowed money enter into the capital standard?

A. No, it does not. If I said that I made a mistake. It is wholly-owned capital. You have to have not borrowed money, but you can borrow money at times to carry on your business.

Q. What you really meant was you borrowed money for working capital?

A. That is right, to carry on the regular business. [54]

Q. That was irrespective of the capital standard requirements set up by General Motors?

A. That is right. The only thing we signed of General Motors was we would not draw any money out of the business until the capital standard requirements were up.

Q. Do you know of your own knowledge whether

(Deposition of F. Norman Phelps.)

or not most of Mr. Kenyon's properties were in the name or stood in the name of, and belonged to, J. A. K. Co. in 1948?

A. I really don't know what and how they were.

Q. Do you know of your own knowledge the approximate value in December, 1948 of the stock in the three corporations owned by J. A. K. Co.?

Mr. Townsend: I think we can stipulate to that.

The Witness: I could take the percentage and figure it out for you, but I——

Mr. Townsend: I will stipulate to that. Your question was the stock ownership by J. A. K. Co.

Q. (By Mr. Thayer): Well, the value of the stock owned by J. A. K. Co.?

A. Well, we can take the net worth and then take the percentage they had of each one and figure it out for you.

Q. Mr. Phelps, in the direct dealer selling agreement between Chevrolet Motor Division and a dealer, are the parties on Paragraph 3 always the same persons who own an interest in the corporation, if it is a corporate dealer? [55]

A. Not always. They are usually the actual operators of the business.

Q. They are the people who operate the business?

A. They are the operators of the business, the ones that contact Chevrolet, the ones that do the actual work around the dealership, the ones that Chevrolet hold responsible.

Q. It has been stipulated that in 1950 Capitol Chevrolet purchased all of the stock then owned

(Deposition of F. Norman Phelps.)

by Mr. Kenyon in that corporation. It has also been stipulated that Howell Chevrolet Company purchased from Mr. Kenyon all of the stock in that corporation owned by Mr. Kenyon and that Mid-Valley purchased from you all of the stock in that corporation owned by you and Mrs. Phelps. Those purchases destroyed the proportionate interest which you had so carefully maintained in 1948. Was General Motors informed or the Chevrolet Motor Division of General Motors informed of what you proposed to do in these 1950 changes?

A. They were.

Q. You discussed it with them beforehand?

A. We did.

Q. Did they raise any objection?

A. None.

Q. Do you know why they did not object to this change in proportionate interests when they had objected to the [56] change in 1948?

Mr. Townsend: Respondent objects to that question as calling for hearsay, and further that the witness is not qualified to answer.

Q. (By Mr. Thayer): Why did not they object to the change in proportionate interest in 1950 when they objected in 1948?

A. Because in 1950 I bought out Kenyon's interest, and Alice and I had Capitol Chevrolet all ourselves. Kenyon bought out the interest that I had in Mid-Valley, and he owned all of Mid-Valley. That was the big two right there. The only reason back in those days that they suggested we keep everything the same was so we wouldn't have any



(Deposition of F. Norman Phelps.)

arguments and stuff like that. It was the only reason.

Q. Based upon your experience in your various executive capacities with Chevrolet Motor Division, do you know what General Motor's policy was toward dissension in dealerships?

A. Certainly I do. If they had dissension in dealerships, they cancelled you.

Q. In 1950 was there any dissension between you and Mr. Kenyon?

A. Not any real dissension. I would not say there was any real dissension. It was just a case that he wanted to go down in Southern California all the time, I guess, and so we just decided that—he suggested that we split up. There [57] was not, maybe, the same friendly relationship, but we didn't really——

Q. Was Chevrolet Motor Division advised of the fact that there was at least the potential ground of dissension?

A. I do not think so; no. I don't think we did. All I asked was would they have any objections if I took all of Capitol and Jim took all of Mid-Valley, and that Jim would get out of Howell, and they said there would be no objection.

Mr. Thayer: That is all.

Q. (By Mr. Aiken): Mr. Phelps, I hand you now Petitioners' Exhibit 26 and particularly desire to call your attention to page 5 of that exhibit and ask you to read it to yourself.

(The witness read page 5 of Exhibit 26.)

Q. (By Mr. Aiken): With respect to any liens

(Deposition of F. Norman Phelps.)

or encumbrances that were ever placed on the stock of a Chevrolet dealership, did you feel obligated to advise Chevrolet of the existence of the proposal to put a lien or borrow money on stock?

A. Will you repeat that question?

Q. With respect to any liens or encumbrances that were ever placed on the stock of a Chevrolet dealership, did you feel obligated to advise Chevrolet of the existence or the proposal to put a lien or borrow money on stock? [58]

A. If we ever had to deposit money on Chevrolet stock with a bank to borrow money, Chevrolet Motor Division should have been advised.

Q. In fact, there is a division of General Motors that is known as Motor Accounting Division which checks dealerships to ascertain that as a part of its audit?

A. That is correct, in principal cities only.

Q. And while you were a Regional Manager, was there any policy in Chevrolet respecting dealers pledging General Motor's dealership stocks to banks, and so on?

A. That was the reason for Trusts and all that sort of thing not being able to hold any stock. There was an incident that occurred back East where the principal died and the bank came in, and they owned a part of the dealership; and Chevrolet Motor Division had to deal directly with directors of banks who knew nothing about Chevrolet franchises, and that was the background, I understand, for the saying that no Trusts or any banks could own any part of a dealership.

(Deposition of F. Norman Phelps.)

Mr. Townsend: Did this occur while you were with General Motors?

The Witness: Yes.

Mr. Townsend: You know of your own knowledge, then?

The Witness: Yes.

Q. (By Mr. Aikens): I am not certain that the answer is responsive to [59] the question that I asked. The question that I would like to ask now is was there a policy of Chevrolet Motor Division against dealers using Chevrolet dealership stock as collateral with banks and financial companies as a general rule?

A. There certainly would be.

Q. And was there such a policy?

A. I don't remember whether such a policy or not existed, but it was just never done. It was just one of those unwritten laws. I don't remember as to a policy.

Q. As Regional Manager did you ever advocate that they go out and deposit their stocks for any company?

Mr. Townsend: Respondent objects to the question.

The Witness: Certainly not.

Q. (By Mr. Aikens): Do you have any stock or own any stock in Howell Chevrolet Company today? A. No.

Q. You have completely retired from having any financial interest in that corporation?

A. That is right.

Mr. Aikens: That is all.

(Deposition of F. Norman Phelps.)

Recross Examination

Q. (By Mr. Townsend): Is it your testimony that the prime movers in rejecting and formulating the various plans considered in this [60] redemption were Mr. Kenyon and Mr. Dempsey; that you personally didn't enter a great deal into it?

Mr. Aikens: I am going to object on the part of Howell Chevrolet upon the grounds that it is ambiguous and particularly in the use of the words "prime factors" or "prime moving parties."

The Witness: I will be glad to tell you. You want to know the facts. I talked to Chevrolet. They told me what they wanted done. I, in turn, talked to Mr. Kenyon. I, in turn, talked to Mr. Dempsey. I told them, "Figure out how you can do it." Mr. Dempsey figured it out. Mr. Kenyon was down here, and they had a lot of contacts together, much more than I did, because I was operating up in Sacramento; and they came out with this plan. Does that answer your question?

Q. (By Mr. Townsend): Yes, it does. When you reduced your working capital below minimum requirements, as set by General Motors, was it necessary to get their permission to do so?

A. It was very necessary to get their permission. I informed the Regional Manager at the time that we would leave every bit of money in the business before we drew any dividends or anything else out, and that we would be very frugal and if they would just play along with us, we were certain we could get our capital standards up to meet their requirements in a short space of time; and

(Deposition of F. Norman Phelps.)

the only reason they were below [61] was because this emergency came up when they insisted they get the Trust and the holding company out of the corporation.

Q. Now, under this Direct Dealer Selling Agreement, Exhibit 24, at the time you entered into the agreements you and Mrs. Phelps owned stock in Capitol Chevrolet. Would General Motors have objected if you had transferred Mrs. Phelps' stock to your name? A. I don't think so.

Q. Why?

A. Well, because we were married in a community property state. Half of everything that she had belonged to me, anyway, and half of everything I had belonged to her.

Q. All right. Did Mr. Kenyon consult anyone before he usually voted the stock of the Trust, the Patricia May Kenyon Trust?

A. No. He had complete jurisdiction over the Trust.

Q. Why would there be any arguments if you had a larger interest in the corporations than Mr. Kenyon after this redemption? It would seem that there would be less chance for arguments if one man was largely in control than if you had two men with equal control.

A. Well, I can see, putting myself in Chevrolet Motor Company, that if you have three dealerships that are going along pretty well and maybe doing modestly, why disrupt an outstanding job? Let it go along just the same. I would [62] have said,



(Deposition of F. Norman Phelps.)

"Let's don't rock the boat. You are getting along fine. Just keep on selling more Chevrolets."

Q. I believe you stated there would be less chance for argument that way?

A. That is right.

Q. Arguments between you and Mr. Kenyon or——

A. If you and I were in business, and we were both strong-minded people, and you owned 51 per cent, and I owned 49 per cent, why, we might be very good friends; but some time you might want to show your authority, and if both of us just owned 50 per cent, neither one had the authority. That would be their thinking.

Q. Did Mr. Dempsey represent you in Federal income tax matters?

A. Yes, he did.

Q. And also the corporations?

A. Yes, he did.

Q. And was there any policy of General Motors against a stock of the dealerships being pledged with the corporation itself to secure personal drawings, say, of one of the owners?

A. I don't understand.

Q. Was there any policy of General Motors with respect to a dealer himself pledging his stock with his own corporation to secure a personal drawing or a loan from this [63] corporation?

A. Oh, no. That would be perfectly permissible. It would not change anything if he needed something quick and would pay it back at the end of the year. That would be perfectly all right.

(Deposition of F. Norman Phelps.)

Q. I have no further questions.

Q. (By Mr. Aikens): I have one question. Were a dealer to borrow on money from his own corporation and pledge that corporation's stock to that corporation it would affect, detrimentally, the net working capital position of that corporation, would it not?

A. Affect the net working capital?

Q. Yes. A. No.

Q. Mr. Phelps, on all advances or loans to officers, where does the amount of that loan show on General Motor's statement?

A. Deferred asset.

Q. Does that deferred asset add to your current assets so as to determine net working capital in accordance with the standards of Chevrolet?

A. You could take out capital from above the line, put it down in the bottom of the line, and your net worth would [64] be the same. You would reduce your net working capital by that amount.

Q. By the amount that was borrowed?

A. That is right.

Mr. Aikens: That is all.

#### Recross Examination

Q. (By Mr. Townsend): Could you give me very generally what the minimum requirements would be for General Motor's working capital?

A. They make a survey of each and every dealership. Each dealership is different. If you handle—if you are a large dealership, you need a lot of parts, and if you sell a lot of cars, even though

(Deposition of F. Norman Phelps.)

your potentialities are no greater, you have to have more used cars; and they take your experience and they refigure your capital requirements every three months or very six months and then Chevrolet figures it for the dealer's own good so he doesn't take out too much money. It is a very good system, and each one is individual.

Q. Could you tell me by reference to your Exhibit 26 the dealer's capital standard program. What the minimum requirement was for that year with respect to Capitol Chevrolet.

A. Additional capital required to bring it up to the standard. Here is your standard on line 55 on page 3. (Indicating.) That is the capital standard set-up by Chevrolet Motor Division. Over on your right-hand column it [65] shows you the total owned capital. On this one it is \$300,533. The actual owned capital as of 7-31-47 is \$259,621. You have additional capital needed to come up to Chevrolet's requirement of \$40,912. What this says at the bottom is that the dealer will not draw out any money until they meet the General Motor capital requirements.

Q. And did they meet the requirements shortly thereafter?

A. I imagine. Again, I don't know, but I imagine that they did, because \$40,000 in those days wasn't very hard to get.

Q. Would those same figures apply to your other two corporations?

A. Same figures? I don't know.

(Deposition of F. Norman Phelps.)

Q. I mean roughly, for example, of the required standard, and it lists a figure——

A. Each standard has to be worked separately, and it all depended on what the trend would be.

Q. Would you not be able to testify as to the similarity, as far as that is concerned?

A. No. I could tell you by looking at each and every individual capital standard. As to how long it would be and how long it would take, by looking at your financial statement and Chevrolet's reason. If you say you will not draw any money out of the business until they meet those standards, [66] but if you keep drawing it out and don't meet the standard, that is reason for termination for cause, and you lose your Chevrolet franchise or it will not be renewed, because capital is very important.

Mr. Townsend: That is all I have.

Mr. Thayer: May it be stipulated that the deposition may be signed before any notary public and further that whether it be signed or unsigned, it may be used for the same manner and the same purpose and place and for the same intents and purposes as it would be if it were signed?

Mr. Townsend: So stipulated.

Mr. Aikens: So stipulated.

Mr. Townsend: It is stipulated that this deposition may be introduced in evidence at the hearing set for September 12, 1955 at Los Angeles, California. It is further stipulated that the reporter may serve copies on the parties without the necessity of sending them to the Tax Court.

Mr. Aikens: So stipulated.

Mr. Thayer: So stipulated.

(The deposition was closed at 12:30 p.m.)

The undersigned certifies that he has read the foregoing testimony adduced at the place and on the date shown in the above-entitled cause; that the 67 pages of testimony constitute a full, true and correct transcription of said testimony; and that changes, alterations or modifications, if any, have been noted by the notary public, at my suggestion, and initialed by me in each instance.

Sacramento, California, August 25, 1955.

/s/ F. NORMAN PHELPS,  
Deponent

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PETITIONERS' EXHIBIT No. 24

DIRECT DEALER SELLING AGREEMENT

Chevrolet Motor Division, General Motors  
Corporation

In Witness Whereof, the parties hereto have executed this Agreement in duplicate the day and year first above written.

Chevrolet Motor Division,  
General Motors Corporation  
/s/ By A. W. Strang, Zone Manager  
Capitol Chevrolet Company,  
Dealer  
/s/ By F. Norman Phelps, President



Petitioners' Exhibit No. 24—(Continued)

Town and State: Sacramento, Calif. Date: November 1, 1948.

Witness: Ralph W. Robb.

If Dealer is a corporation, show State in which incorporated: California.

Name of Dealer's Bank: Capitol National Bank, Sacramento, California.

Form No. GSD-201-Chevrolet-48

Chevrolet Motor Division—General Motors  
Corporation

Direct Dealer Selling Agreement

This Agreement, made this 1st day of November, A.D. 1948, by and between Chevrolet Motor Division—General Motors Corporation, hereinafter called Seller, and Capitol Chevrolet Company, City and County of Sacramento, California, a corporation, hereinafter called Dealer.

Witnesseth:

In Consideration of the promises hereinafter made by the parties to each other, it is agreed as follows:

First: Seller will sell and dealer will buy Chevrolet motor vehicles and chassis, subject to the terms and conditions hereof, for resale in the following described territory, but not elsewhere, namely:

Exclusive selling rights within the specific Security Area as set forth in the attached "Territory

## Petitioners' Exhibit No. 24—(Continued)

Security Schedule", which schedule is subject to change from time to time, as the Security Area for the location occupied by dealer, and non-exclusive selling rights in all other communities in any of the United States, the District of Columbia or Alaska in which no authorized Chevrolet dealer is located or which are not within the Security Area of an authorized Chevrolet dealer or dealers.

Second: The terms and conditions set forth in the attached "Terms and Conditions—Direct Dealers", bearing Form No. GSD-202-Chevrolet-48 and Identification No. 48-1103, are hereby made a part hereof with the same force and effect as if set forth at length herein.

Third: This is a personal contract, being entered into in reliance upon and in consideration of the personal qualifications of and representations with respect thereto of F. Norman Phelps and James A. Kenyon (jointly), the Dealer, or partner(s) in the dealership, or representative(s) of the Dealer who actively and substantially participate(s) in the ownership and/or operation of the dealership. The individual or individuals designated shall be responsible for any act or omission of any of Dealer's agents or employees which may be contrary to the purposes and objectives of this Agreement or the obligations of Dealer hereunder. Dealer shall not transfer nor assign this Agreement or any right or obligation hereunder nor make nor suffer to be made any substantial change in the ownership, financial interests or active management of Dealer.

Petitioners' Exhibit No. 24—(Continued)

Fourth: This Agreement shall continue in force and govern all relations and transactions between the parties hereto for a term expiring October 31, 1949. At the end of such term, this Agreement shall automatically terminate without notice or action on the part of either party unless sooner terminated as hereinafter provided.

Fifth: This Agreement is not valid until and unless executed by the General Manager, General Sales Manager, an Assistant General Sales Manager, a Regional Manager, an Assistant Regional Manager, or Zone Manager of the Chevrolet Motor Division—General Motors Corporation.

Form No. GSD-202-Chevrolet-48

Identification No. 48-1103

Chevrolet Motor Division—General Motors  
Corporation

Terms and Conditions—Direct Dealers

The following Terms and Conditions have by reference been incorporated in and made a part of the Selling Agreement which shall apply to and govern all transactions, dealings and relations between the parties:

Selling Rights, Terms and Conditions of Sale

1. Exclusive Selling Privilege

For so long a time as Dealer shall continue to sell new Chevrolet motor vehicles and chassis in a manner and to an extent and quantity satisfac-

Petitioners' Exhibit No. 24—(Continued)  
 tory to Seller and while this Agreement shall be and remain in effect, Seller shall not grant to any other or different person, firm, or corporation the privilege of selling new Chevrolet motor vehicles and chassis in Dealer's territory unless Seller, in this Agreement, designates said territory or any part thereof as non-exclusive.

## 2. Seller's Reserved Rights

### A. Non-exclusive Rights

Seller shall have the right to sell directly or through any division or subsidiary of General Motors Corporation any Chevrolet automotive products, either directly or through such distributors or dealers as it may designate, to any of the following classes of customers without obligation or liability to Dealer, to wit:

(1) The United States or any state government or any foreign government, or any municipal corporation or any political subdivision, department, bureau or instrumentality of any such government.

(2) The America Red Cross.

(3) Any division or subsidiary of General Motors Corporation.

(4) Employes of General Motors Corporation and its subsidiaries.

(5) Diplomatic representatives of foreign nations.

### B. Exclusive Rights

Seller reserves the exclusive right to sell any Chevrolet automotive products, directly or through

**Petitioners' Exhibit No. 24—(Continued)**

such distributors or dealers as it may designate to manufacturers of ambulances, invalid coaches, funeral cars, busses, or other commercial vehicles.

\* \* \* \* \*

**Operating Requirements****12. Dealer's Personal Services**

Each person named in Paragraph Third of this Agreement shall devote his full time, attention, and energy to the conduct of Dealer's business hereunder.

**13. Dealer's Place of Business Satisfactory to Seller**

Dealer will maintain a place of business including salesroom, service station, parts and accessories facilities, and used car facilities satisfactory to Seller and will maintain the business hours customary in the trade. Seller shall have the right at all reasonable times in business hours to inspect said place of business.

Dealer will not move to or establish a new location, branch sales office, branch service station or place of business including any used car lot or location without the prior written consent of Seller.

**14. Building Service for Dealer**

Seller will, upon request, but without liability to Dealer with respect thereto, furnish to Dealer a suggested building plan and layout, but such plan and layout will not be intended for use as a complete working plan and will be furnished solely as a suggestion.

**15. Capital Requirements**



## Petitioners' Exhibit No. 24—(Continued)

Since the amount and structure of working capital and net worth required to handle properly the business to be conducted by Dealer hereunder depends upon many factors, including size of market, sales and service facilities required, anticipated volume and others and since Seller has set standards for dealer capital and net worth based on Seller's past experience, Dealer shall establish his owned net working capital and net worth in the respective amount and form specified by Seller. If the amount of owned net working capital or net worth or the way in which either is set up is now or hereafter inadequate in Seller's estimation for the proper handling of Dealer's business, Dealer will take the necessary steps to meet Seller's applicable requirements within the time determined by Seller.

## 16. Accounts and Records

## A. Uniform Accounting System

It is to the mutual interests of Seller and Dealer that uniform accounting systems and practices be maintained by dealers in order that Seller may develop standards of operating performance which will enable dealers to obtain the most satisfactory results from the sales potentials assigned to them and which will enable Seller to prepare composite dealer profit statements periodically to guide Seller in formulating policies beneficial to the dealers' interests.

Accordingly, Dealer will use and keep up to date at all times a satisfactory uniform accounting sys-

## Petitioners' Exhibit No. 24—(Continued)

tem designated by Seller and will furnish to Seller, by the tenth of each month, a complete and accurate financial and operating statement with supporting data covering the preceding month's operations, showing the true and actual condition of Dealer's business. Dealer will maintain said system in strict accordance with the Accounting Manual prescribed by Seller.

## B. Examination of Accounts and Records

In order to assure the maintenance of a uniform accounting system and practices, Dealer will permit an examination of his accounts and records to be made by a person or persons, either in the employ of Seller or acceptable to Seller, at such time or times as Seller may designate. A copy of the report of such examination will be furnished to both Seller and Dealer.

## 17. Satisfactory Sale of Motor Vehicles

Dealer shall develop to Seller's satisfaction the territory herein assigned to him for the resale of Chevrolet motor vehicles and chassis.

## 18. Sales Staff

Dealer shall maintain a staff of salesmen and a selling and customer relations organization adequate to take care of the sales potential of the area served by Dealer.

## 19. Sales and Service Records

In furtherance of the purposes, objectives, and obligations provided for in this Agreement, Dealer will keep complete and up-to-date records regarding the sale and servicing of new Chevrolet motor ve-

Petitioners' Exhibit No. 24—(Continued)

hicles and chassis and will permit Seller at all reasonable times in business hours to inspect such records.

20. Customer Complaints

Dealer will receive, investigate and handle all complaints received from customers or prospective customers with a view to protecting the goodwill of Seller and Dealer in the sale of Chevrolet products.

21. Price to Retail Purchaser

A. Maximum Price

Seller will establish Advertised Delivered Prices on new Chevrolet motor vehicles and chassis at Flint, Michigan, and it is the desire of Seller that all retail customers wherever located be able to purchase such vehicles at not more than these prices, plus transportation charges and the retail installed prices of any optional equipment and accessories selected by the retail purchaser, all as shown in the current sheet of Suggested Maximum Retail Delivered Prices issued to Dealer by Seller from time to time, plus applicable taxes, if any.

Dealer will cooperate with Seller in advertising delivered prices in Dealer's town and will inform retail purchasers of such prices, and will give them itemized invoices covering the details of their purchases.

B. Right of Retail Purchaser to Buy a New Car Without Purchasing Optional Equipment or Accessories

Dealer recognizes that a retail customer has the right to purchase new Chevrolet motor vehicles

## Petitioners' Exhibit No. 24—(Continued)

without being required to purchase any optional equipment or accessories and Dealer therefore will either remove any optional equipment or accessories which such purchaser does not want, or will immediately order a new Chevrolet motor vehicle without such optional equipment or accessories.

## C. Representation as to Transportation Charges

Dealer shall not make any statement intended to lead any purchaser to believe that a greater portion of the selling price of a new Chevrolet motor vehicle or chassis represents transportation charges and Factory Handling Charges than the amounts of such items actually charged to and paid for by Dealer.

\* \* \* \* \*

## C. Adjustments on Sales Outside Territory: Overseas

If a new Chevrolet motor vehicle, chassis or demonstrator is sold by an authorized Chevrolet dealer to a person, firm or corporation whose actual residence, or in case of commercial cars, whose place of business is not in any of the United States, the District of Columbia or Alaska, but is within the territory of the Overseas Division, the selling dealer shall pay as liquidated damages to Seller for disbursement to such Overseas Division, the sum of Thirty-five Dollars (\$35.00) or Fifty-five Dollars (\$55.00) depending on whether voluntary payment is made within forty-eight (48) hours as provided in the previous sub-paragraph B hereof except in the following cases:

Petitioners' Exhibit No. 24—(Continued)

(1) When the purchaser, at the time of such sale, owns or leases and is then occupying or maintaining a residence within the security area of the selling dealer.

(2) When the purchaser is a bona fide tourist in the United States and purchases said motor vehicle, chassis or demonstrator for use in the United States and secures a license therefor at the selling dealer's location.

(3) When the purchaser is in the diplomatic corps of the country of which he is a citizen and is assigned to duty in the United States at the time of such sale.

Claims by the Overseas Division may be filed at any time within four (4) months from the date of the delivery of said motor vehicle, chassis or demonstrator to such purchaser.

In the event that any Chevrolet dealer located in any of the United States, the District of Columbia or Alaska, shall file claim involving the sale of a new Chevrolet motor vehicle, chassis or demonstrator by said Overseas Division, Seller shall investigate said claim and if in Seller's opinion said claim is just, Seller shall make payment to dealer subject to and in accordance with the provisions of sub-paragraph B hereof.

D. Construction

The decision of Seller on all matters in connection with claims hereunder including the purchaser's actual residence and the classification of the motor vehicle, chassis, or demonstrator in-



Petitioners' Exhibit No. 24—(Continued)

involved, shall be final and conclusive on all parties concerned.

The term "residence", as used herein, shall mean the actual residence of the purchaser of passenger cars for non-commercial purposes and the actual place of business of the purchaser of trucks and passenger cars for commercial purposes as of the date of the sale. All facts relating and pertinent to the question of residence, including occupancy, point of use of such motor vehicle, shall be taken into consideration so that the actual and true place of residence or place of business, as the case may be, may be determined.

Claims filed under this Paragraph 22 will be decided against any dealer who brings to the attention of the purchaser of the motor vehicle involved in said claim the fact that such claim has been filed or who involves such owner in the matter in any way.

The term "dealer" herein shall include associate dealers as well as direct dealers.

23. Care of Owner

Recognizing the importance of owner goodwill, Dealer will furnish prompt and satisfactory service at reasonable cost to Chevrolet owners. In furtherance thereof Dealer will:

A. Conditioning of New Motor Vehicles

Condition each new motor vehicle and chassis before delivery, in accordance with Seller's pre-delivery inspection schedule.

Petitioners' Exhibit No. 24—(Continued)

B. Owner's Service Policy

Execute and deliver to each person who purchases a new Chevrolet motor vehicle or chassis from Dealer, an "Owner's Service Policy," on forms furnished by Seller as amended from time to time. Dealer will promptly perform and fulfill all the terms and conditions of said Policy.

C. Stock of Parts

Carry in stock at all times during the life of this Agreement an adequate number and assortment of parts and accessories to render proper service to owners of Chevrolet motor vehicles and chassis in Dealer's zone of influence.

D. Representation as to Parts

Not sell, offer for sale, or use in the repair of Chevrolet motor vehicles and chassis as genuine new Chevrolet repair parts, any part or parts which are not in fact genuine new Chevrolet repair parts as defined in sub-paragraph A of Paragraph 11 hereof.

E. Special Tools

Buy such special tools developed by Seller, as Seller shall deem necessary for Dealer to render proper service to owners. Further, Dealer authorizes and directs Seller to ship or cause to be shipped to Dealer in advance of delivery of new models, such special tools, the cost of which shall not exceed One Hundred Dollars (\$100.00), as Seller deems essential to service such new models properly. Dealer will pay for such new-model tools promptly on receipt thereof.

Petitioners' Exhibit No. 24—(Continued)

F. Mechanical Staff

Employ a sufficient number of competent mechanics to meet adequately the service requirements of the Chevrolet owners in Dealer's zone of influence.

G. Flat Rate System

Install the Chevrolet Flat Rate System of time allotments for service work as recommended and furnished by Seller and charge Seller for policy, warranty, and any other work performed by Dealer for Seller's Account on the basis of such time allotments and at one-half ( $\frac{1}{2}$ ) of the labor rates related thereto, as agreed upon with Seller.

H. Warranty Adjustment

Install any part or parts furnished by Seller under the warranty set forth in Paragraph 10 hereof on motor vehicles sold by Dealer without expense to the owner of such vehicles and Seller will, if the replaced part is returned to and found by Seller to be defective, pay or credit to Dealer one-half ( $\frac{1}{2}$ ) of the flat rate charge for installing the new part or parts according to the Flat Rate System of time allotments and labor charges then in effect in Dealer's business as provided in subparagraph G above.

I. Customer Relationship

Make every reasonable effort to satisfy owners of Chevrolet motor vehicles and chassis in his territory, or, if Dealer is on a non-exclusive basis, to satisfy all persons purchasing Chevrolet motor vehicles and chassis from Dealer, and in pursuance

Petitioners' Exhibit No. 24—(Continued)  
thereof establish regular contact either by correspondence or personal interview, with such owners or purchasers. All complaints received by Dealer which cannot be readily remedied, shall be promptly reported to Seller with the name of the owner making same.

#### J. Inspection of Facilities

Permit Seller to inspect and check over Dealer's service facilities and stock of parts and accessories at any reasonable time in business hours.

#### 24. Signs

Dealer will purchase, erect, and maintain at his expense the following signs as hereinafter specified:

A. A standard product electric sign in a conspicuous place outside his showrooms provided the erection thereof is not prohibited by municipal ordinance or statute.

B. A standard authorized service sign in a suitable location on the outside of Dealer's place of business.

C. Such other signs as are necessary to advertise his business properly on a basis mutually satisfactory to both Seller and Dealer.

#### 25. Chevrolet Name and Trade-Marks

##### A. Seller's Exclusive Rights

Seller is entitled to the use of the word "Chevrolet", and the Chevrolet trade-mark or trade-marks, including the distinctive outline or form thereof, as applied to motor vehicles and chassis, parts and accessories, and of the goodwill attached thereto.

Petitioners' Exhibit No. 24—(Continued)

B. Discontinuance of Use Upon Termination

If the word "Chevrolet" is used in the name under which Dealer's business is conducted or the word "Chevrolet" or any Chevrolet trade-mark, including the distinctive outline or form thereof, is used in any sign or advertising displayed by Dealer, Dealer will, upon termination of this Agreement, or upon the request of Seller, discontinue the use of the same. Thereafter Dealer will not use, either directly or indirectly, in connection with any motor vehicle business, any Chevrolet trade-mark, including the distinctive outline or form thereof, the word "Chevrolet" or any other name, title, expression or mark so nearly resembling the same as to be likely to lead to confusion or uncertainty or to deceive the public. If Dealer is a corporation in whose corporate name the word "Chevrolet" is used, Dealer will promptly have the corporate name changed, eliminating said word "Chevrolet" therefrom.

C. Dealer's Liability for Failure to Discontinue Use

If Dealer, after termination of this Agreement, shall refuse or neglect to keep and perform the provisions of sub-paragraph B hereof, Dealer shall reimburse Seller for all costs, attorneys' fees and other expenses incurred by Seller in connection with legal action to require Dealer to comply therewith.

\* \* \* \* \*

Termination of Agreement

28. Termination

A. Dealer may terminate this Agreement by writ-



## Petitioners' Exhibit No. 24—(Continued)

ten notice of termination delivered to Seller, such termination to be effective one (1) month after receipt by Seller of such notice.

## B. Termination for Cause

(1) If Seller or Dealer requires a license for the performance of any obligation hereunder or in connection herewith in any state or jurisdiction where this Agreement is to be performed, then and in such event if either of the parties hereto shall fail to secure or maintain a license or renewal thereof, or if such license shall be suspended or revoked, either party may immediately terminate this Agreement and all orders theretofore given to Seller and not delivered, by giving to the other party written notice of such termination.

(2) If Dealer does not develop the territory herein assigned to him to the satisfaction of Seller or does not conduct his business in accordance with any requirement set forth in Paragraphs 12 and 13, Paragraphs 15 to 20, inclusive, or Paragraph 23 hereof, to the satisfaction of Seller, Seller may terminate this Agreement by giving to Dealer written notice of termination to be effective three (3) months after receipt thereof.

(3) In the event that Dealer, after receiving notice from Seller of termination pursuant to subsection (2) above, or in the event that Dealer after having knowledge that he will not be offered a new Selling Agreement by Seller to become effective upon the automatic expiration of this Selling Agreement, enters into a Selling Agreement for a

## Petitioners' Exhibit No. 24—(Continued)

different make of motor vehicle, this Agreement and all obligations hereunder, including orders theretofore given to Seller but not delivered, shall terminate immediately, without notice, anything contained in this Agreement to the contrary notwithstanding.

(4) Seller may terminate this Agreement immediately by delivering to Dealer or his representative written notice of such termination in the event of the happening of any of the following:

a. Death, incapacity, or the removal, resignation, withdrawal, or elimination from the dealership for any reason of Dealer or any person named in Paragraph Third of this Agreement.

b. Any sale, transfer, relinquishment, voluntary or involuntary, by operation of law or otherwise, of any substantial interest in the direct or indirect ownership or management of the Dealer or dealership.

c. Any dispute, disagreement, or controversy between or among principals, partners, managers, officers or stockholders of Dealer which, in the opinion of Seller, may adversely affect the ownership, operation, management, business or interest of Dealer, dealership, or Seller.

d. Insolvency of Dealer; the filing of a voluntary petition in bankruptcy by Dealer; the filing of a petition to have Dealer declared bankrupt, provided it is not vacated within thirty (30) days from the date of filing; the appointment of a receiver or trustee for Dealer, provided such appointment is

Petitioners' Exhibit No. 24—(Continued)  
not vacated within thirty (30) days from the date of such appointment; the execution by Dealer of an assignment for the benefit of creditors; the conviction of Dealer or any principal officer, or manager of Dealer of any crime which, in the opinion of Seller, may adversely affect the ownership, operation, management, business or interest of Dealer, dealership, or Seller.

(5) Seller or Dealer may terminate this Agreement immediately by delivering to the other party written notice of termination in the event that the other party violates or fails to comply with any term or provision of this Agreement for which termination is not otherwise specifically provided for in this Paragraph 28.

## 29. Transactions After Termination

### A. Dealer's Obligations

Any termination of this Agreement shall not release Dealer from the obligation to pay any sum which may then be owing Seller, or from the obligation to pay for any special motor vehicle, chassis or equipment for same as defined in sub-paragraph C of Paragraph 3 hereof which may have been ordered by Dealer and not shipped by Seller prior to such termination.

### B. Dealer's Orders

In the event of termination of this Agreement pursuant to the provisions of Paragraph 28A, 28B (2) or Paragraph 28B (4), sub-section a, b or c thereof, but not otherwise, Seller will use its best efforts to furnish Dealer with Chevrolet motor

## Petitioners' Exhibit No. 24—(Continued)

vehicles and chassis to fill his bona fide retail orders on hand on the date of termination not to exceed, however, the total number of motor vehicles and chassis delivered to Dealer by Seller during the three (3) months immediately preceding the date of termination, subject, however, to the following further conditions and limitations:

(1) Within ten (10) days following termination, Dealer shall deliver to Seller a written schedule of Dealer's bona fide retail orders on hand on the date of termination. Such schedule shall show the name and address of each retail customer and the details with respect to each motor vehicle ordered, including model, body type, color and accessories and shall specify each bona fide order against which Dealer desires Seller to make delivery up to the three (3) months' total number of motor vehicles required to be delivered by Seller as above described. Those orders for which delivery is thus specified by Dealer, when approved by Seller, shall constitute Dealer's Schedule of Termination Deliveries. No change or substitution may be made by Dealer in such Schedule of Termination Deliveries and Seller shall not be obligated to make deliveries of any motor vehicle to Dealer except as specified therein. In the event of Dealer's failure to deliver to Seller the detailed schedule above required, Dealer shall have no further rights hereunder.

(2) Dealer shall accept any motor vehicle required to be delivered by Seller hereunder against



Petitioners' Exhibit No. 24—(Continued)

Dealer's Schedule of Termination Deliveries immediately upon notification by Seller of the availability to Dealer of such vehicle. In the event of his failure to do so, Dealer shall have no further right to receive such vehicle or any other vehicle in lieu thereof.

(3) Vehicles shall be delivered by Seller hereunder in substantial accordance with the schedule and basis of delivery in effect with respect to other dealers in the same zone at the time of Dealer's termination.

(4) Dealer shall give Seller notice immediately upon cancellation for any reason of any retail order set forth in Dealer's Schedule of Termination Deliveries.

(5) In the event of the cancellation for any reason of any retail order set forth in Dealer's Schedule of Termination Deliveries before delivery by Seller of a motor vehicle to apply against such order, Seller shall be released from any obligation to make delivery of such vehicle.

(6) Dealer shall provide proper and adequate facilities in accordance with the terms and provisions of this Agreement to effect the delivery and handling of motor vehicles to be supplied under this sub-paragraph 29B.

C. Effect of Transactions After Termination

The acceptance of orders from Dealer or the continuance of sale of products to Dealer or any other act of Seller after termination of this Agreement shall not be construed as a renewal of this Agree-



Petitioners' Exhibit No. 24—(Continued)

ment for any further term nor as a waiver of the termination.

\* \* \* \* \*

General Provisions

32. Dealer Not Made Agent or Legal Representative of Seller

This Agreement of which these Terms and Conditions are a part does not constitute Dealer the agent or legal representative of Seller for any purpose whatsoever. Dealer is not granted any express or implied right or authority to assume or to create any obligation or responsibility in behalf of or in the name of Seller or to bind Seller in any manner or thing whatsoever.

33. Responsibility for Dealer's Commitments

Dealer shall be solely responsible for any and all obligations or liabilities incurred or assumed by him in the performance hereof, and Seller shall not be held responsible in any manner therefor, irrespective of any suggestion or recommendation with respect thereto by Seller or any of its employes or representatives unless Seller has agreed to assume the responsibility, either in whole or in part, by written agreement executed by its General Manager or its General Sales Manager, except insofar as it is specifically provided otherwise in this Agreement.

34. Notices

Any notice required to be given by either party to the other hereunder or in connection herewith shall be in writing and delivered personally or by

## Petitioners' Exhibit No. 24—(Continued)

mail. Notices to Dealer shall be directed to Dealer, or his representative at Dealer's place of business; notices to Seller shall be directed to the Zone Manager of the area in which Dealer is located.

## 35. No Implied Waivers

The failure of either party at any time to require performance by the other party of any provision hereof shall in no way affect the full right to require such performance at any time thereafter. Nor shall the waiver by either party of a breach of any provision hereof constitute a waiver of any succeeding breach of the same or any other such provision nor constitute a waiver of the provision itself.

## 36. Applicable Law

This Agreement is to be governed by and construed according to the laws of the State of Michigan. If, however, any provision herein in anywise contravenes the laws of any state or jurisdiction where this Agreement is to be performed, such provision shall be deemed not to be a part of this Agreement therein.

## 37. Sole Agreement of Parties

This Agreement shall be binding upon Seller when signed by the General Manager, General Sales Manager, an Assistant General Sales Manager, a Regional Manager, an Assistant Regional Manager, or Zone Manager of Seller. However, no change in, addition to, or erasure of, any printed portion of this Agreement (except the filling in of blank lines) shall be valid or binding upon Seller

Petitioners' Exhibit No. 24—(Continued)  
unless it is expressly declared to be a modification of this Agreement and is approved as such in writing by the General Sales Manager of Seller.

There is no other agreements or understandings, either oral or in writing, between the parties affecting this Agreement or relating to the sale or servicing of Chevrolet motor vehicles, chassis, parts or accessories. This Agreement cancels and supersedes all previous agreements between the parties hereto.

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PETITIONERS' EXHIBIT No. 25

Capital Chevrolet Co. November 1, 1948  
1300 K Street, Sacramento, Calif.

Gentlemen:

Please take notice that the Capital Standard Agreement dated 8-15-47 heretofore executed by you shall continue in full force and effect and shall constitute a part of the new Chevrolet Selling Agreement entered into with you this date provided:

1. If such Capital Standard Agreement was executed by you prior to November 1, 1947, it shall be and the same is hereby amended to read and apply to the new Chevrolet Selling Agreement as follows:

a. In the first paragraph on Page 3, the reference to "Paragraph 13" is amended to read "Para-

graph 15 (in Texas Selling Agreement 'Paragraph 14')".

b. In the second paragraph on Page 3, the reference to "Subparagraph 24B (2)" is amended to read "Subparagraph 28B (2) (in Texas Selling Agreement 'Subparagraph 26B (2)')".

c. In the paragraph on Page 5, the reference to "Subparagraph 24B (5)b" is amended to read "Subparagraph 28B (4)b (in Texas Selling Agreement 'Subparagraph 26B (4) b')".

2. If such Capital Standard Agreement was executed by you subsequent to October 31, 1947 but prior to November 1, 1948, it shall be and the same is hereby amended to read and apply to the new Chevrolet Selling Agreement as follows:

a. In the first paragraph on Page 3, the reference to "Paragraph 14" is amended to read "Paragraph 15 (In Texas Selling Agreement 'Paragraph 14')".

b. In the second paragraph on Page 3, the reference to "Subparagraph 24B (2) (in Texas Selling Agreement 'Subparagraph 23B (2)')" is amended to read "Subparagraph 28B (2) (in Texas Selling Agreement 'Subparagraph 26B (2)')".

c. In the paragraph on Page 5, the reference to "Subparagraph 24B (4)b (in Texas Selling Agreement 'Subparagraph 23B (4)b')" is amended to read "Subparagraph 28B (4)b (in Texas Selling Agreement 'Subparagraph 26B (4)b')".

Will you please indicate your understanding and agreement to the foregoing by signing the attached receipt and returning it promptly to your Zone Office.

Very truly yours,

T. H. Keating,  
General Sales Manager  
Chevrolet Motor Division  
General Motors Corporation

/s/ By A. W. Strang, Zone Manager

(Dealer should file this letter with his New Selling Agreement.)





**GENERAL MOTORS**  
**DEALERS CAPITAL STANDARD PROGRAM**



**CAPITAL STANDARD AGREEMENT**

WITH

Dealer CAPITOL CHEVROLET COMPANY

Street Address 1300 K STREET

City SACRAMENTO (Zone No.) CALIFORNIA State

Dealer's Retail Planning Potential 513 Zone OAKLAND, CALIF.



SUPPLEMENTAL AGREEMENT by and between the undersigned Dealer, hereinafter called "the Dealer" and Chevrolet Motor Division, General Motors Corporation, hereinafter called "Chevrolet" supplementing current Chevrolet Selling Agreement in effect between the parties.

WITNESSETH:

WHEREAS, the parties desire to interpret and define the precise application to the Dealer's Business of the provisions and requirements of the aforesaid current Chevrolet Selling Agreement with regard to the Dealer's capital requirements and the ownership and management of the Dealer's business in consideration of which, among other things, Chevrolet heretofore offered and entered into such Selling Agreement with the Dealer; NOW, THEREFORE, it is agreed between the parties that the aforesaid provisions and requirements of the Selling Agreement more specifically referred to hereafter shall be interpreted to comprehend the following agreements by and warranties to Chevrolet on the part of the Dealer:

1. Dealer Capital Standard Program—The subject Dealer agrees to the following Dealer Capital Standard Program:

LINE	CASH STANDARD—One Average Month Total Expenses	Average Month		Agreed Standards
		1941	Cur. Year	
1	Average Month Variable Selling Expenses	4337	4760	5700
2	Average Month Fixed Overhead Expenses	10807	21400	23000
3	STANDARD—CASH—TO EQUAL AVERAGE MONTH TOTAL EXPENSES	15144	26160	28700

RECEIVABLES

STANDARD—One Average Month Investment

4	Average Month Notes Receivable	2154	6997	60000
5	Average Month Accounts Receivable	16644	82248	50000
6	STANDARD—AVERAGE MONTH TOTAL RECEIVABLES	18798	89245	110000

COMPANY CARS AND NEW CARS

STANDARD—Number of Company Cars agreed upon by Chevrolet and the Dealer and One Average Month Stock of New Cars and Trucks based on Schedule "A" below. Total Dollar Inventories of Company Cars and New Cars shall be based on the current year-to-date New Car and Truck Cost of Sales Average per unit, including Freight and Handling. The Dealer's equity in Company Car and New Car Inventories shall be not less than either (a) 80% when based on Retail Planning Potential Volume, or (b) 10% when based on Double Retail Planning Potential Volume, plus the indicated increase in the average month Used Car Dollar Inventory on the basis of Double Retail Planning Potential Volume, whichever is greater.

	Average Month		Standard Based on	
	1941	Cur. Year	Retail Planning Potential Volume	Double Retail Plan Potential Volume
7	Average Month No. Passenger Company Cars	-	5	9
8	Average Month No. Commercial Company Cars	-	1	3
9	AVERAGE MONTH TOTAL NO. COMPANY CARS	12	6	12
10	Dealer's Average Month Retail Planning Potential		43	86
11	Percentage Required for Average Month Stock (Secure from Schedule "A" Below)		60 %	50 %
12	AVERAGE MONTH NEW CAR UNIT INVENTORY (Line 10 x Line 11)		26	43
13	TOTAL AVERAGE MONTH COMPANY CAR AND NEW CAR UNIT INVENTORIES (Total Lines 9 and 12)		32	55
14	Current Year-to-Date Average New Car Unit Cost of Sale		1132	1132
15	TOTAL COMPANY AND NEW CAR AVERAGE MONTH DOLLAR INVENTORIES (Line 13 x Line 14)		36224	62260
16	Dealer's Minimum Percentage of Equity		80 %	10 %
17	Dealer's Minimum Equity (Line 15 x Line 16)		28979	6226
18	Indicated Increase in Used Car Dollar Inventory based on Double Retail Planning Potential Volume (Copy from Line 24)			31898
19	STANDARD—MINIMUM COMPANY CAR AND NEW CAR EQUITY—WHICHEVER IS GREATER (Total Lines 17 and 18)		(Whichever is Greater) 28980	38124

SCHEDULE "A"—NEW CAR AND TRUCK STOCK AS PER CENT OF AV. MONTH RETAIL PLANNING POTENTIAL

Average Month Retail Planning Potential	1 to 4	5 to 12	13 to 17	18 to 21	22 to 25	26 to 29	30 to 33	34 to 38	39 to 42	43 to 46	47 to 50	Over 50
Percentage to be Applied	125%	100%	95%	90%	85%	80%	75%	70%	65%	60%	55%	50%





L I N E	USED CARS	Standard Based on Retail Planning Potential Volume
	STANDARD—One Average Month Stock to be determined as follows: Dealer's Average Month Retail Planning Potential (Line 10 above)—multiplied by Dealer's 1941 Selling Ratio—multiplied by the Dealer's 1941 Used Car Average Selling Price increased by 50%.	
20	Average Month Retail Planning Potential (Line 10 above)	43
21	Dealer's 1941 Selling Ratio (Used to New)	1.9
22	Indicated Average Month Used Car Unit Inventory (Line 20 x Line 21)	82
23	Dealer's 1941 Used Car Average Selling Price Increased by 50%	389
24	STANDARD—AVERAGE MONTH USED CAR DOLLAR INVENTORY (Line 22 x Line 23)	31898

**PARTS**

STANDARD—Three Months Supply based on Current Year-to-Date Average Month Total Parts Cost of Sales.

25	Current Year-to-Date Average Month Total Parts Cost of Sales	17923
26	STANDARD—THREE MONTHS SUPPLY OF PARTS (Line 25 x 3)	53769

**ACCESSORIES**

STANDARD—Two Months Supply of Accessories Other Than with New Cars  
Plus One Month Supply of Accessories with New Cars.

27	Current Year-to-Date Average Month Cost of Sales— Accessories Other Than with New Cars	1134
28	STANDARD—TWO MONTHS SUPPLY (Line 27 x 2)	2268
29	Current Year-to-Date Average Cost of Sales of Accessories with New Cars—Per New Car and Truck Sold Retail	76.71
30	STANDARD—ONE MONTH SUPPLY (Line 29 x Retail Planning Potential on Line 10)	3299
31	STANDARD—TOTAL ACCESSORIES (Total Lines 28 and 30)	5567

**PREPAID EXPENSES**

STANDARD—One Average Month Investment.

32	STANDARD—CURRENT YEAR-TO-DATE AVERAGE MONTH PREPAID EXPENSES	7595
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**ALL OTHER CURRENT ASSETS**

STANDARD—One Average Month Investment.

33	STANDARD—CURRENT YEAR-TO-DATE AVERAGE MONTH TOTAL OF ALL OTHER INVENTORIES NOT COVERED ABOVE (Excl. Cash, Securities and Disc. Rec.)	11059
34	TOTAL CURRENT ASSETS (Total of Lines 3-6-19-24-26-31-32-33)	286712

**LESS CURRENT LIABILITIES**

35	One Month Supply of Parts (Amount Shown on Line 25)	17923
36	One Month Supply of Accessories (Total of Lines 27 and 30)	4433
37	One Month Supply of Any Miscellaneous Inventories Purchased on Open Account	3322
38	STANDARD—DEDUCTIBLE LIABILITIES (Total Lines 35-36-37)	25678

**OWNED NET WORKING CAPITAL STANDARD**

(Line 34 Minus Line 38)

261034



Page 3

LINE	FIXED AND DEFERRED ASSETS	
40	Dealer's Current Equity in Land and Buildings Used in the Business	—
41	Amount Not Less Than Current Total Net Book Value of All Other Fixed and Deferred Assets Used in the Business	39499
42	Total Net Value of Non-Franchise Investments	—
43	STANDARD—FIXED AND DEFERRED ASSETS (Total Lines 40, 41 and 42)	39499
44	TOTAL OWNED CAPITAL STANDARD (Total Lines 39 and 43)	300533

## RECAP OF STANDARDS

LINE	NET WORKING CAPITAL		From Line	FIXED AND DEFERRED ASSETS		From Line	TOTAL OWNED CAPITAL
45	Cash	3	28700				
46	Receivables	6	110000				
47	Company Cars and New Cars	19	38124				
48	Used Cars	24	31898				
49	Parts	26	53769				
50	Accessories	31	5567	Land and Buildings	40	—	
51	Prepaid Expenses	32	7595	Other Fixed and Deferred Assets	41	39499	
52	All Other Current Assets	33	11059	Non-Franchise Investments	42	—	
53	TOTAL CURRENT ASSETS	34	286712				
54	Less: Liabilities	38	25678				
55	STANDARDS OWNED NET WORKING CAPITAL	39	198,000 261034	OWNED FIXED AND DEFERRED ASSETS	43	40820 39499	(From Line 44) 238,000 300533
56	ACTUAL OWNED CAPITAL AS OF 7/31 1947		220122			39499	259621
57	ADDITIONAL OWNED CAPITAL REQUIRED		40912			—	40912

The foregoing Chevrolet Dealer Capital Standard Program for the subject Dealer hereby agreed to by the undersigned parties is made in accordance with and supplements Paragraph 13 of the current Chevrolet Selling Agreement in accordance with said Paragraph, moreover, it is agreed between the undersigned parties that the amounts of Owned Net Working Capital and Total Owned Capital required for the proper operation of the subject dealership are \$261034 and \$300533, respectively, and that until such time as the actual Owned Net Working Capital and/or Total Owned Capital equal or exceed such amounts, 50% of Net Profits (after Income Tax applicable to the business) are to be retained in the dealership business and that thereafter the Owned Net Working Capital and Total Owned Capital will be maintained at such amounts as the minimums, provided, nevertheless, the above required minimum Owned Net Working Capital and required minimum Total Owned Capital must in no event be attained or supplied by Dealer on or before August 15, 1948, and thereafter maintained.

The Dealer's failure to comply with this requirement constitutes a ground for termination of the current Chevrolet Selling Agreement pursuant to Subparagraph 24B(2) of the provision thereof entitled "Termination for Cause."

In the event that the date specified is beyond the date of termination of the current Chevrolet Selling Agreement pursuant to any provision thereof, such fact shall not be deemed a commitment on the part of Chevrolet to continue the current Selling Agreement or to offer Dealer a new Selling Agreement for a period beyond the termination date.



2. Warranty as to Statement of Net Worth—The subject Dealer warrants the following to be a true and correct reconciliation of net worth representing the dealership status as of July 31 1947

RECONCILIATION OF NET WORTH (Enter All Amounts in Nearest Even Dollars)			DEALERSHIP IS CURRENTLY OPERATED AS A:	
1	Cash and Equivalents	143454		
2	Securities	---		
3	Discount Receivable	4325		
4	TOTAL	147779	Proprietorship	<input type="checkbox"/>
5	Less: Accts. Payable—Trade Creditors	22698	Partnership	<input type="checkbox"/>
6	Receivable Credit Balances	45814	Corporation	<input checked="" type="checkbox"/>
7	Service Contract Deposits	3574		
8	Other Accounts Payable	1151		
9	Accrued Liabilities	33883		
10	Reserve for Income Taxes (Corp.)	60874		
11	Other Reserves & Bonus	51648		
12	TOTAL	158766	*****	
13	ADJUSTED CASH POSITION (Line 4 Minus Line 12)	→ 71861	NET WORTH SHOWN ON LINE 51 BELOW CURRENTLY CONSISTS OF:	
14	New Cars (Incl. F & H) Units ( 34 )	40321		
15	Company Cars Units ( 5 )	4908		
16	Total	45129		
17	Less: Due on New Cars and Company Cars	24609		
18	NET EQUITY NEW AND COMPANY CARS	20520	Proprietorship or Partnership	
19	Special Bodies and Truck Equipment	4388		
20	Parts	134482		
21	Accessories	16399		
22	Gas, Oil and Grease	420	Investment Accounts \$	
23	Paint Materials	652		
24	Total	176861	Drawing Accounts \$	
25	Less: Notes Payable (Except on Cars)	---		
26	NET EQUITY NEW MERCHANDISE	→ 176861	Current Year Net Profit \$	
27	Receivables	66753		
28	Less: Reserve for Bad Debts	4634		
29	NET VALUE RECEIVABLES	→ 62119		
30	Used and Repos. Cars Units ( 66 )	44439	Total Net Worth \$	
31	Less: Used Car Loans	---		
32	Used Car Reserve	8888	Corporation	
33	NET VALUE USED AND REPOSSESSED CARS	→ 35551	Capital Stock Out- standing \$ 85000	
34	Miscellaneous Inventories	→ 6813	Surplus \$ 75299	
35	Prepaid Expenses	→ 10639	Dividends \$ ---	
36	NET WORKING CAPITAL (Total Lines 13, 26, 29, 33, 34 and 35)	220122	Current Year Net Profit \$ 99321	
37	Less: Long-Term Liabilities (Excl. Bldg. Mtge.)	→ ---	Total Net Worth \$ 259621	
38	OWNED NET WORKING CAPITAL (Line 36 Minus Line 37)	220122		
39	Land and Buildings (Less Mtge. and Reserve)	---		
40	Mach. and Shop Equipment (Less Reserve)	8504		
41	Parts and Access. Equipment (Less Reserve)	9341		
42	Furniture and Fixtures (Less Reserve)	3000		
43	Service Cars (Less Reserve)	11132		
44	Leaseholds and Improvements (Less Amort.)	---		
45	NET VALUE FIXED ASSETS	→ 31977		
46	Officers Notes and Accounts	792		
47	Advances to Employees	6		
48	Other Deferred Assets	6724		
49	TOTAL DEFERRED ASSETS	→ 7522		
50	NON-FRANCHISE INVESTMENTS	→ ---		
51	NET WORTH (Total Lines 38, 45, 49 and 50)	259621		





3. **Warranty as to Ownership and Management**—The subject Dealer warrants that the following constitutes the management and the entire direct and indirect ownership of the dealership as of the date hereof and agrees that any deviation from the same constitutes sufficient cause for the immediate termination by Chevrolet Motor Division, General Motors Corporation, of the Chevrolet Selling Agreement currently in effect between the parties, pursuant to Subparagraph 24B(5)b of the provision thereof entitled "Termination for Cause."

(1) Name of Individuals, Partners or Stockholders Having Ownership or Management Interest (Mark "X" Opposite Persons Named in Paragraph Third of Selling Agreement)	(2) Title If Any	(3) Amount of Investment if a Partnership or Proprietorship	If a Corporation, Show the Number of Shares of Stock (Each Type) Owned by Each Stockholder			(7) If any of the Investment Shares in Column 2 or 3 has been borrowed, Show Name and Address of Lender, and the Amount of Loan, and the Date of Termination of the Loan Upon Repayment (Check) (Specify Date)
			No. Shares (4)	Type (5)	Book Value (6)	
P. Norman Phelps	Pres.		213	Common	\$65,058.	GMAD - L. A. \$15,000.
Alice Phelps	Secy.-Treas.		212	"	64,752.	None
James A. Kanyon, Trustee for Patricia May Kanyon			170	"	51,924.	None
J. A. E. Co. - A Nevada Corp.	Vice-Pres.		255	"	77,887.	None
James A. Kanyon	Pres.		See the J. A. E. Co.			J. A. E. Co.
Phillip J. Moffatt	Gen. Mgr.		0			
TOTAL	XXXX		850		259,621.	

IN WITNESS WHEREOF, the parties have executed this Supplemental Agreement to the aforesaid Chevrolet Selling Agreement this

15th day of August, 1947

CAPITOL CHEVROLET COMPANY

Dealer Firm Name

By Thomas A. Schen  
(Person named in Paragraph Third of Selling Agreement)

President

CHEVROLET MOTOR DIVISION  
GENERAL MOTORS CORPORATION

J. P. Kating  
General Sales Manager

By M. J. Kating  
Sales Manager



PETITIONERS' EXHIBIT No. 27

[Letterhead of Chevrolet Motor Division]

Capitol Chevrolet Company      November 1, 1948  
1300 K Street, Sacramento, California

Gentlemen:

In delivering to you herewith new Chevrolet Selling Agreement to be effective for the term commencing November 1, 1948, we direct your attention to the fact that our action is not to be regarded as evidence of satisfaction on our part with the operation of your dealership as to financial setup within the requirements of Paragraph 15 thereof. On the contrary, your operation is unsatisfactory in that all or part of the ownership of the dealership is held by a trust.

As you know, the Chevrolet Selling Agreement is a personal contract for a stated and limited term only and is dependent for its continuance during that term upon the direct relations by and between Chevrolet Motor Division and the dealership principal named in Paragraph Third thereof. In keeping with the nature of this Agreement and to facilitate the handling of operating details by and between Chevrolet Motor Division and the dealership principal on a basis permitting of control solely by the dealership principal and without actual or potential interference by any other party and also to insure the financial stability of the Chevrolet dealership organization for the mutual advantage of the Chevrolet dealership and of Chevrolet Motor Division, it is the desire and policy of Chevrolet

Motor Division that all ownership of the Chevrolet dealership be held directly by individuals approved by Chevrolet Motor Division.

The new Chevrolet Selling Agreement is herewith delivered to you, therefore, upon the express representation by you that action will be taken to effect the foregoing objective not later than April 30, 1949.

Will you please indicate your understanding accordingly by signing the attached carbon copy of this letter and return the same promptly to the undersigned with the executed copy of the new Chevrolet Selling Agreement.

Very truly yours,

T. H. Keating

General Sales Manager

Chevrolet Motor Division

General Motors Corporation

/s/ By A. W. Strang, Zone Manager

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PETITIONERS' EXHIBIT No. 28

[Letterhead of Chevrolet Motor Division]

Capitol Chevrolet Company      November 1, 1948  
1300 K Street, Sacramento, California

Gentlemen:

In delivering to you herewith new Chevrolet Selling Agreement to be effective for the term commencing November 1, 1948, we direct your attention to the fact that our action is not to be regarded as evidence of satisfaction on our part with the opera-



tion of your dealership as to financial setup within the requirements of Paragraph 15 thereof. On the contrary, your operation is unsatisfactory in that all or part of the ownership of the dealership is held, in effect, by a holding company.

As you know, the Chevrolet Selling Agreement is a personal contract for a stated and limited term only and is dependent for its continuance during that term upon the direct relations by and between Chevrolet Motor Division and the dealership principal named in Paragraph Third thereof. In keeping with the nature of this Agreement and to facilitate the handling of operating details by and between Chevrolet Motor Division and the dealership principal on a basis permitting of control solely by the dealership principal and without actual or potential interference by any other party and also to insure the financial stability of the Chevrolet dealership organization for the mutual advantage of the Chevrolet dealership and of Chevrolet Motor Division, it is the desire and policy of Chevrolet Motor Division that all ownership of the Chevrolet dealership be held directly by individuals approved by Chevrolet Motor Division.

The new Chevrolet Selling Agreement is herewith delivered to you, therefore, upon the express representation by you that action will be taken to effect the foregoing objective not later than September 30, 1949.

Will you please indicate your understanding accordingly by signing the attached carbon copy of this letter and return the same promptly to the

The foregoing is hereby agreed to and accepted this 1st day of November 1948.

Mid-Valley Chevrolet Company  
/s/ By F. Norman Phelps

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PETITIONERS' EXHIBIT No. 30

[Letterhead of Chevrolet Motor Division]

Mid-Valley Chevrolet Co.  
San Bernardino, California

Nov. 1, 1948

Gentlemen:

In delivering to you herewith new Chevrolet Selling Agreement to be effective for the term commencing November 1, 1948, we direct your attention to the fact that our action is not to be regarded as evidence of satisfaction on our part with the operation of your dealership as to financial setup within the requirements of Paragraph 15 thereof. On the contrary, your operation is unsatisfactory in that all or part of the ownership of the dealership is held, in effect, by a holding company.

As you know, the Chevrolet Selling Agreement is a personal contract for a stated and limited term only and is dependent for its continuance during that term upon the direct relations by and between Chevrolet Motor Division and that the dealership principal named in Paragraph Third thereof. In keeping with the nature of this Agreement and to facilitate the handling of operating details by and between Chevrolet Motor Division and the dealership principal on a basis permitting of control

solely by the dealership principal and without actual or potential interference by any other party and also to insure the financial stability of the Chevrolet dealership organization for the mutual advantage of the Chevrolet dealership and of Chevrolet Motor Division, it is the desire and policy of Chevrolet Motor Division that all ownership of the Chevrolet dealership be held directly by individuals approved by Chevrolet Motor Division.

The new Chevrolet Selling Agreement is herewith delivered to you, therefore, upon the express representation by you that action will be taken to effect the foregoing objective not later than September 30, 1949.

Will you please indicate your understanding accordingly by signing the attached carbon copy of this letter and return the same promptly to the undersigned with the executed copy of the new Chevrolet Selling Agreement.

Very truly yours,

T. H. Keating  
General Sales Manager  
Chevrolet Motor Division  
General Motors Corporation

/s/ By J. W. Steele, Zone Manager

The foregoing is hereby agreed to and accepted this 1st day of November 1948.

Mid-Valley Chevrolet Company  
/s/ By F. Norman Phelps

PETITIONERS' EXHIBIT No. 31

[Letterhead of Chevrolet Motor Division]

Howell Chevrolet Co.,  
Glendale, California

November 1, 1948

Gentlemen:

In delivering to you herewith new Chevrolet Selling Agreement to be effective for the term commencing November 1, 1948, we direct your attention to the fact that our action is not to be regarded as evidence of satisfaction on our part with the operation of your dealership as to financial setup within the requirements of Paragraph 15 thereof. On the contrary, your operation is unsatisfactory in that all or part of the ownership of the dealership is held by a trust.

As you know, the Chevrolet Selling Agreement is a personal contract for a stated and limited term only and is dependent for its continuance during that term upon the direct relations by and between Chevrolet Motor Division and the dealership principal named in Paragraph Third thereof. In keeping with the nature of this Agreement and to facilitate the handling of operating details by and between Chevrolet Motor Division and the dealership principal on a basis permitting of control solely by the dealership principal and without actual or potential interference by any other party and also to insure the financial stability of the Chevrolet dealership organization for the mutual advantage of the Chevrolet dealership and of Chev-

vrolet Motor Division, it is the desire and policy of Chevrolet Motor Division that all ownership of the Chevrolet dealership be held directly by individuals approved by Chevrolet Motor Division.

The new Chevrolet Selling Agreement is herewith delivered to you, therefore, upon the express representation by you that action will be taken to effect the foregoing objective not later than April 30, 1949.

Will you please indicate your understanding accordingly by signing the attached carbon copy of this letter and return the same promptly to the undersigned with the executed copy of the new Chevrolet Selling Agreement.

Very truly yours,

T. H. Keating  
General Sales Manager  
Chevrolet Motor Division  
General Motors Corporation  
/s/ By J. W. Steele, Zone Manager

The foregoing is hereby agreed to and accepted this 1st day of November 1948.

Howell Chevrolet Company  
/s/ By F. Norman Phelps



PETITIONERS' EXHIBIT No. 32

[Letterhead of Chevrolet Motor Division]

Howell Chevrolet Co.,  
Glendale, California

Nov. 1, 1948

Gentlemen:

In delivering to you herewith new Chevrolet Selling Agreement to be effective for the term commencing November 1, 1948, we direct your attention to the fact that our action is not to be regarded as evidence of satisfaction on our part with the operation of your dealership as to financial setup within the requirements of Paragraph 15 thereof. On the contrary, your operation is unsatisfactory in that all or part of the ownership of the dealership is held, in effect, by a holding company.

As you know, the Chevrolet Selling Agreement is a personal contract for a stated and limited term only and is dependent for its continuance during that term upon the direct relations by and between Chevrolet Motor Division and the dealership principal named in Paragraph Third thereof. In keeping with the nature of this Agreement and to facilitate the handling of operating details by and between Chevrolet Motor Division and the dealership principal on a basis permitting of control solely by the dealership principal and without actual or potential interference by any other party and also to insure the financial stability of the Chevrolet dealership organization for the mutual advantage of the Chevrolet dealership and of Chevrolet Motor Division, it is the desire and policy of

Chevrolet Motor Division that all ownership of the Chevrolet dealership be held directly by individuals approved by Chevrolet Motor Division.

The new Chevrolet Selling Agreement is herewith delivered to you, therefore, upon the express representation by you that action will be taken to effect the foregoing objective not later than September 30, 1949.

Will you please indicate your understanding accordingly by signing the attached carbon copy of this letter and return the same promptly to the undersigned with the executed copy of the new Chevrolet Selling Agreement.

Very truly yours,

T. H. Keating  
General Sales Manager  
Chevrolet Motor Division  
General Motors Corporation

/s/ By J. W. Steele, Zone Manager

The foregoing is hereby agreed to and accepted  
this 1st day of November 1948.

Howell Chevrolet Company

/s/ By F. Norman Phelps

PETITIONERS' EXHIBIT No. 33

Mr. Gus Culbertson  
Chevrolet Motor Division  
Los Angeles, California

September 17, 1948

Dear Gus:

Recently a representative of your office notified me that it is Chevrolet Motor Division's desire that

no "holding company" or "trust" own any part of the stock of a Chevrolet dealership.

I just want you to know that both Mr. Kenyon and I are anxious to cooperate in every way possible. This matter has been referred to our attorney and as soon as he advises us the steps we should take, we will get in touch with you and attempt to work out a satisfactory solution.

Very truly yours,

F. Norman Phelps

FNP:ns

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PETITIONERS' EXHIBIT No. 34

Mr. A. W. Strang  
Chevrolet Motor Division  
Oakland, California

September 18, 1948

Dear Art:

Recently Clarence DeLong notified me that it is Chevrolet Motor Division's desire that no "holding company" or "trust" own any part of the stock of a Chevrolet dealership.

I just want you to know that both Mr. Kenyon and I are willing and anxious to cooperate in every way possible. This matter has been referred to our attorney and as soon as he advises us the steps we should take, we will get in touch with you and attempt to work out a satisfactory solution.

Very truly yours,

F. Norman Phelps

FNP:ns

PETITIONERS' EXHIBIT No. 35

Mr. A. W. Strang                      October 16, 1948  
Chevrolet-Oakland  
10910 East 14th Street, Oakland 4, California

Dear Art:

Mr. DeLong and I had a conference concerning our situation after the Contracting Meeting here in Sacramento last Monday; then on Wednesday Mr. DeLong called and asked that I give you the information concerning our setup as I gave it to him verbally.

You will remember that previously I informed you we would do anything that Chevrolet Motor Company required concerning our capital structure, and inasmuch as the Division wishes us to eliminate the Trust and the Holding Company, I informed you we would arrange to do this.

As you know, the J. A. K. Co., which is a Nevada Corporation owned by James A. Kenyon, now owns 30 per cent of the stock in Capitol Chevrolet Company, 30 per cent in Mid Valley Chevrolet, and 20 per cent in Howell Chevrolet. Our attorney advises that if this J. A. K. Co. were to be liquidated at the present time, the tax situation is such that Mr. Kenyon and I would be subject to approximately \$90,000.00 tax.

It would seem that if it were possible for you to permit us to postpone the change until the Revenue Act of 1949 passes both the House and the Senate, it would be most helpful to us.

Also, the complications would be the same in the separation of the Center Chevrolet at Colton from Mid Valley Chevrolet in San Bernardino.

So in both instances it unquestionably would work a hardship on us to make the changes at the present time—and if at all possible we would like to wait and see if this new tax bill is passed. It is my understanding that it passed the House at the last session, but was buried in the Senate due to the great number of Bills in the closing days of the session.

At the present time we are working on a way to buy out the Trust by the different corporations. We believe this can be handled because although it is an irrevocable Trust, Mr. Kenyon has jurisdiction over the Trust until his daughter becomes of age.

In eliminating both the Trust and the Holding Company, it may be necessary to reduce our Net Working Capital substantially, and this might result in our being under-capitalized according to the established standard requirements.

We will give you a detailed report as to just what we would like to do in the very near future, at which time I will come to your office and explain the entire transaction in detail. I would appreciate very much having Mr. Connell sit in on this discussion because, as you know, the deals in Southern California are also involved.

Because of the complications, I would appreciate Chevrolet Motor Division giving us six months or



a year to work out of the seeming difficulties with which we are faced at the present time.

Very truly yours,

F. Norman Phelps, President

cc—Mr. J. L. Connell, Mr. Gus Culbertson, Mr. J. A. Kenyon.

FNP:ns

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PETITIONERS' EXHIBIT No. 36

AGREEMENT

This Agreement, made and entered into this 21 day of December, 1948, by and between F. Norman Phelps, Alice Phelps, James A. Kenyon, Jackson Howell, and James A. Kenyon, Trustee of the Patricia May Kenyon Trust.

Witnesseth:

Whereas the parties hereto are all stockholders of Howell Chevrolet Company except James A. Kenyon, who is the owner and holder of all of the outstanding capital stock of J. A. K. Co., a Nevada Corporation, which owns 180 shares of the capital stock of Howell Chevrolet Company; and

Whereas, the Chevrolet Division of General Motors Corporation has notified Howell Chevrolet Company that the stock ownership of the Patricia May Kenyon Trust in Howell Chevrolet Company must be discontinued; and

Whereas, the parties hereto have agreed upon a plan whereby the said demands of the Chevrolet

Division of General Motors Corporation shall be met; and

Whereas, the said plan contemplates that the Howell Chevrolet Company shall purchase 100 shares of its outstanding capital stock from F. Norman Phelps and Alice Phelps, 100 shares from Jackson Howell, and 100 shares from the Patricia May Kenyon Trust, and that, subject to the approval of the Superior Court of the State of California, James A. Kenyon will purchase from the said Patricia May Kenyon Trust 20 shares of the said Howell Chevrolet Company capital stock; and

Whereas, in the event that the Court approves said purchase by James A. Kenyon from the Patricia May Kenyon Trust the voting control of F. Norman Phelps and Alice Phelps, Jackson Howell and James A. Kenyon will be equal, but in the event that the Court shall not permit of the purchase by the said James A. Kenyon from the said Patricia May Kenyon Trust of 20 shares of Howell Chevrolet Company capital stock and the said stock is purchased by the Howell Chevrolet Company, the voting control will not be equal as among these parties;

Now, Therefore, in consideration of the sum of One Dollar (\$1.00) in hand paid each to the other, and other valuable considerations, F. Norman Phelps and Alice Phelps together and Jackson Howell agree that, in the event that the said Superior Court shall not approve of the application of James A. Kenyon to purchase 20 shares of the

Howell Chevrolet Company capital stock from the Patricia May Kenyon Trust, said Howell Chevrolet Company may purchase the said 20 shares at the price of \$465.08 per share, and that in such event they will sell to said James A. Kenyon  $6\frac{2}{3}$  shares each of Howell Chevrolet Company capital stock now owned by them respectively (F. Norman Phelps and Alice Phelps  $6\frac{2}{3}$  shares and Jackson Howell  $6\frac{2}{3}$  shares) at the said price of \$465.08 per share; and James A. Kenyon agrees to buy from F. Norman Phelps and Alice Phelps  $6\frac{2}{3}$  shares of Howell Chevrolet Company capital stock and from Jackson Howell  $6\frac{2}{3}$  shares of the said capital stock of Howell Chevrolet Company at said per share price.

This agreement shall be binding upon the heirs and assigns of the parties hereto.

In Witness Whereof, the parties hereto have hereunto set their hands the day and year first above written.

/s/ F. Norman Phelps

/s/ Alice Phelps

/s/ James A. Kenyon

/s/ Jackson Howell

/s/ Jas. A. Kenyon, Trustee

Trustee of the Patricia May  
Kenyon Trust

[Title of Tax Court and Cause.]

## STIPULATION TO TAKE DEPOSITION

It Is Hereby Stipulated and Agreed by and between the parties hereto by their respective counsel of record that the testimony of J. L. Connell, a witness on the part of the petitioners, whose address is 728 Harcourt Road, Gross Point, Michigan, be taken at 9:00 a.m. o'clock on August 30, 1955 at 1104 Pacific Mutual Building, 523 West 6th Street, Los Angeles 14, California, before Helen D. Wilson, a notary public in and for the county of Los Angeles, State of California, and that if said deposition is not completed on said day it will be continued from time to time thereafter until completed; that said deposition and testimony, when taken, may be read and used in evidence in said cause on any trial thereof or in any proceeding therein, subject to the same objections and exceptions as if said witness were personally present, but without objection or exception to the time, place and manner of taking the same, or to the form of the questions, unless noted at the time.

/s/ WELLMAN P. THAYER,  
Counsel for Petitioners, F. Norman Phelps, Alice  
Phelps and James A. Kenyon Trust, James A.  
Kenyon Trustee.

/s/ CAMERON B. AIKENS,  
Counsel for Petitioners, Jackson Howell and Vir-  
ginia Howell

/s/ JOHN POTTS BARNES, REM  
Chief Counsel, Internal Revenue Service, Counsel  
for Respondent.

[Title of Tax Court and Causes.]

## DEPOSITION OF JOHN LESTER CONNELL

Room 1104, Pacific Mutual Building, 523 West  
Sixth Street, Los Angeles 14, California. Tuesday,  
August 30, 1955.

### Testimony for Petitioners

The parties met, pursuant to Stipulation, at 1:00  
p.m. at the above time and place.

Present: Wellman P. Thayer, Esq., of Dempsey,  
Thayer, Deibert & Kumler, 523 West Sixth Street,  
Los Angeles 14, California, for Petitioners F. Nor-  
man Phelps and Alice Phelps and the James A.  
Kenyon Trust. Cameron B. Aikens, Esq., of Getz,  
Aikens & Manning, 6435 Wilshire Boulevard, Los  
Angeles 48, California, for Petitioners Jackson  
Howell and Virginia Howell. Mark Townsend, Esq.,  
(Hon. John Potts Barnes, Esq., Chief Counsel, In-  
ternal Revenue Service) 1135 Subway Terminal  
Building, Los Angeles, California, for the Com-  
missioner.

### Proceedings

#### JOHN LESTER CONNELL

called as a witness for and on behalf of the Peti-  
tioners, having been first duly sworn, was examined  
and testified as follows:



(Deposition of John Lester Connell.)

Direct Examination

Q. (By Mr. Thayer): Will you state your full name, please?

A. John Lester Connell, C-o-n-n-e-l-l.

Q. What is your occupation, Mr. Connell?

A. I am presently on special assignment to the General Sales Manager of Chevrolet Motor Division, GM.

Q. How long have you been employed by Chevrolet Motor Division of the General Motors Corporation?

A. This is my 25th year.

Q. What offices have you held during the course of that employment?

A. I have been Zone Manager in Des Moines, Zone Manager in New Orleans, Assistant Regional Manager, Chicago, Regional Manager, Kansas City, Regional Manager here on the Coast and now——

Q. When did you start your present work?

A. I started with the company in December 10, 1931. At that time I was Special Representative, and three years later I was made Zone Manager.

Q. When did you first become a Regional Manager?

A. March 5 of 1945 at Kansas City.

Q. During the year 1948 what was the nature of your employment?

A. Regional Manager of the Pacific Coast Region located at Oakland, California.

Q. During the year 1948 was one of your official duties, as Regional Manager for the Pacific Coast Region, to familiarize yourself with directives from the General Sales Manager to the dealers

(Deposition of John Lester Connell.)

within your region? A. Yes, sir.

Q. Do you know, of your own knowledge, whether, during the year 1948, Chevrolet Motor Division of General Motors Corporation had a policy concerning the ownership of interests in dealerships by trusts and holding companies?

A. There was such a policy issued in 1948. I couldn't tell you what month.

Q. What was that policy?

A. The policy was to the effect that trusts and/or holding companies could not own, as such, interest in Chevrolet dealerships.

Q. I show you six documents which have been marked Petitioners' Exhibits 27 through 32, both inclusive, and will ask you to examine them.

(The witness examined the exhibits.)

Q. (By Mr. Thayer): Referring to Petitioners' Exhibits 27 through 32, both inclusive, I will ask you whether the statements contained in such letters to the effect that the operation of the three dealerships mentioned therein was unsatisfactory in that all or part of the ownership of such dealerships was held by a trust and a holding company, were in conformance with the policy of Chevrolet Motor Division, which you have just mentioned.

A. They all state that they are unsatisfactory in that all or part of the ownership is held either by a trust or a holding company. It further states in Paragraph 3 that, "The new Chevrolet selling agreement is herewith delivered to you, therefore, upon the express representation by you that action will be taken to effect the foregoing objective not

(Deposition of John Lester Connell.)

later than April 30, 1949." This is a standard form letter that we used in all cases of this kind that were in violation of either the trust policy or the holding company policy. We were going on record with these men who had previously been advised verbally that they were in violation of a policy now in effect by the Chevrolet Motor Division.

Q. Those letters, then, were issued in conformance with that policy?

A. That's right, and these letters, of course, were issued by the zone managers who operated under the Regional Office and handled all the operations of the dealerships and only referred to the Region those cases which they could not bring to a conclusion.

Q. Do you know, of your own knowledge, whether any dealers within the Pacific Coast Region were affected by the Chevrolet Motor Division policy?

A. Yes, there were some five or six.

Q. During the year 1948 did you know, of your own knowledge, that the Capitol Chevrolet Company, the Mid-Valley Chevrolet Company and the Howell Chevrolet Company were operating in contravention of the policy which you have just mentioned?

A. I did. I want to make this statement here that prior to the issuance of this policy, none of these dealerships were in violation of anything, because we had no such policy in effect prior to 1948. A dealership having a trust or a holding company owning any part of that dealership after our 1948

(Deposition of John Lester Connell.)

Selling Agreement were advised that they would have to, in some form or other, remove the interest owned by the holding company or trust to qualify for a new Selling Agreement.

Q. In your capacity as Regional Manager of the Pacific Coast Region, did you, during the year 1948, counsel or advise any of the affected dealers within your region concerning the policy above mentioned?

A. I had two dealers who, for some reason or another, did come to the Region to discuss their problems with me, not only the dealerships in question, but specifically one other dealership.

Q. In your official capacity as Regional Manager of the Pacific Coast Region of Chevrolet Motor Division, did you at any time during the year 1948 advise any of the officers of Capitol Chevrolet Company, Mid-Valley Chevrolet Company or Howell Chevrolet Company of the Chevrolet Motor Division policy which you have mentioned above?

A. I might want to qualify the word "advise" but I did discuss this entire matter with one of the officials who came to me at that time with their own problem as to when and how they might qualify.

Q. What official was that?

A. Mr. Phelps, Norman Phelps.

Q. Will you please relate the circumstance, or circumstances under which Mr. Phelps came to you and discussed with you the matter of this policy?

A. The whole matter had been first discussed with Mr. Phelps by our then Zone Manager, I be-



(Deposition of John Lester Connell.)

lieve Mr. Strang in Oakland, who advised him of the policy going into effect, and because both the trust and the holding company owned part of their dealerships, that they would have to qualify in order to be given a new selling agreement the following year. He had some conditions at that time—let me put it this way: At no time did he object to going along with us on our new policy, but he was asking for time and felt that they possibly couldn't qualify between the time we first talked to him and the time that our new selling agreement would be issued. I don't recall a particular circumstance, but it was agreed that there would be some extension given to him, but that we were not waiving our policy, and one of the letters was then sent to all of his agencies notifying them that we were signing this agreement, but he would have to meet our requirements before the new one would be offered. In effect, that is what our letter said. At that time, too, because of what we really call about three and a half dealerships, actually three dealerships and a smaller dealership which was wholly owned by one of the dealerships, it was my suggestion to Norm that because our operation had been mutually satisfactory as the operation had been going along, that to qualify under this new provision I felt it would be more than fair that each retain, after meeting our new requirements, the same per cent of ownership in these dealerships, as otherwise it would work a hardship on one or the other who might be at the time in violation, realizing that in this particular instance the viola-



(Deposition of John Lester Connell.)

tion was mainly on the part of one partner affecting another partner. I thought it no more than fair that after the trust and holding company had withdrawn their interest, that all partners still retain a like percentage in their dealerships. That I discussed with Mr. Phelps.

Q. When you referred to "each" and again to "the partners," were you referring to Mr. Phelps, Mr. Kenyon and Mr. Howell?

A. That's right.

Q. (By Mr. Aikens): Mr. Connell, you refer to the signing of the contract. Are you referring to a direct dealer selling agreement?

A. I shouldn't have said "contract." We don't have any such thing. I am referring to our selling agreement.

Q. And the date of that selling agreement, for what period are we referring to?

A. We are referring to what would be normally known as the 1949 Selling Agreement effective November 1, 1948. We were offering the 1948 Selling Agreement with the provision that they meet our requirement before we would offer to discuss with them the signing of their 1949 Selling Agreement.

Q. I show you Petitioners' Exhibit No. 24 and ask you whether or not this was the type of agreement that you referred to in your last answer given to Mr. Thayer's question.

A. Yes, that is a photostat of our regular selling agreement.

Q. (By Mr. Thayer): Mr. Connell, based upon your long experience as an executive of Chevrolet

(Deposition of John Lester Connell.)

Motor Division of General Motors Corporation, do you have an opinion as to the effect of the failure or refusal of Capitol Chevrolet Company, Mid-Valley Chevrolet Company or Howell Chevrolet Company to comply with the policy of Chevrolet Motor Division, as set forth in Petitioners' Exhibits 27 through 32, both inclusive?

A. It was my considered opinion in my capacity that either this dealership or any other dealer, if they were in violation, would again be notified, after having first received this letter notifying them that they were in violation, that their present selling agreement had been given them with the understanding that during its life they would comply with our new policy. They would then be sent another letter in which they would be told a new selling agreement was not being offered, because they were not complying with the policy of the company, stating, in effect why and how they were not qualifying. We have many different policies, of course, that might come under that same heading.

Q. Mr. Connell, were the three dealerships, Capitol Chevrolet Company, Mid-Valley Chevrolet Company and Howell Chevrolet Company, all in the Pacific Coast Region?      A. That's right.

Mr. Thayer: That is all.

#### Cross Examination

Q. (By Mr. Townsend): Mr. Connell, despite the fact that a dealer was a corporation in form, Chevrolet Division would still look to certain key

(Deposition of John Lester Connell.)

individuals and hold those individuals personally responsible, would they not?

A. We do. In fact, our selling agreement recognizes only the person named in Paragraph 3.

Q. In other words, you wouldn't hold every shareholder in the corporation responsible, just those key individuals?

A. We would. I would have to give you my own opinion, we would look to that man to meet our requirements by seeing that the corporation qualified. We wouldn't offer him that right to sign again in Paragraph 3. I might say that I don't know of anyone that was not offered a selling agreement. In this case they qualified. We merely gave them some time to qualify, and they did, so we went along.

Q. Now, as you know, Mrs. Phelps also owned stock in these corporations.

A. Yes, I know that.

Q. Would the Chevrolet Division object if she transferred or sold her stock to Mr. Phelps?

A. No, but we again have a policy that covers that. The question would have to clear first to the Zone, the Zone then has to pass it to the Region. If the Zone says they see no objection to her selling the stock, they clear it to the Region, and the Regional Manager then has to approve it. He can turn it down and it goes no further, but after the Regional Manager approves, it still has to clear the Central Office. Then the approval comes back to the Region, and the Zone is notified.

Q. As a practical matter the fact that Mr.

(Deposition of John Lester Connell.)

Phelps was one of the individuals that you looked to who is named in Paragraph 3, in your opinion would there be any objection to his wife's transferring her stock to him?

A. I see no objection.

Q. Does Chevrolet Division, or did Chevrolet Division of General Motors, have any policy with respect to equal ownership of these corporations, and I speak of corporations Mid-Valley——

A. No, only this: The man in Paragraph 3, either in a partnership or a corporation, must own outright a minimum of 25 per cent of whatever the issued stock of the corporation is. But a change of one share of stock still has to clear through the same steps I told you about.

Q. The only requirement, then, that Chevrolet Division of General Motors had was that a key individual, one named in Paragraph 3, own at least 25 per cent?

A. Must own, or he cannot be in Paragraph 3.

Q. Then Chevrolet Division would only object if a shareholder's interest fell below 25 per cent?

A. That's right.

Q. Would they object if he was completely eliminated?

A. Then our selling agreement would not be in effect, and we would have to start all over again and have a new man who could qualify to be in Paragraph 3. He must not only be acceptable, but he must be qualified as an operator.

Q. Would you consider Mr. Phelps qualified as the only individual? If he attained complete own-

(Deposition of John Lester Connell.)

ership of this corporation, would you consider him qualified to be the only individual named in Paragraph 3?

A. I wouldn't know. I wouldn't say the only one qualified.

Q. In other words, you do have selling agreements with just one man named in Paragraph 3?

A. Oh, yes, and we have others with more than one.

Q. Would you consider Mr. Phelps as well qualified as any other dealership where one man might be named in Paragraph 3?

A. That's right. We recognize that or he wouldn't be there.

Q. Based on your experience with General Motors, can you see where any objection would have been raised if Mr. Phelps, solely, had been named in Paragraph 3 of a dealership?

A. There would have been no objection to that. In fact, I think that is the way the selling agreement was in effect. I think his signature was the only one there.

Q. You spoke about your suggestion to Mr. Phelps with respect to the equal ownership of these dealerships. Was that your personal suggestion, or was it General Motor's policy that you were expressing?

A. I was not quoting policy. That was my own operation experience. I felt that we had been going along fine. Our relations were splendid, and to make any change in the operation at that time, I didn't feel would be good. I felt, further, and this related



(Deposition of John Lester Connell.)

to Mr. Kenyon, if he had to withdraw his holding company and his trust, which he had, he would be practically pushed out of the deal by Mr. Phelps; that he would either have to raise more money or have to go out and borrow money or take in another partner to put in the money necessary to meet our capital requirements; that it would be no more than fair that they keep like percentages. As to how they took the money out, that is none of my business. My position was merely to see that they met the requirements of their selling agreements and any policies.

Q. Did Mr. Phelps understand that it was your suggestion rather than General Motor's suggestion or policy?

Mr. Thayer: I wish to interpose an objection. I object to that question as calling for a conclusion of the witness, a conclusion for which no foundation can or has been laid.

Mr. Aikens: I join in that objection.

The Witness: Yes, I believe he understood that.

Q. (By Mr. Townsend): Was anything said during that conversation about the fact that a new selling agreement would not be issued unless they kept equal ownership?

A. We don't go to that extent. The letters that we issue are put out by our Central office, and they explain in effect what we are telling the dealers, and our dealers usually go along with us on that, as you can see from this letter.

Q. Excuse me, Mr. Connell, I am not discussing the fact about the trust or holding company hav-

(Deposition of John Lester Connell.)

ing to be eliminated. What I am expressly referring to is the fact that they keep equal ownership was your suggestion.

A. It was my prerogative as Manager here on the Coast to keep my dealerships operating as I felt they should be operated, and that was my personal opinion at that time.

Q. Was there any implied threat whatsoever that a new selling agreement would not be issued?

A. None whatsoever on that.

Q. Could Mr. Phelps have understood any implied threat from your suggestion?

A. No reason to.

Q. You know that in 1950 Mr. Kenyon and Mr. Phelps did split up their ownership?

A. That's right.

Q. Did you approve of that?

A. I had to in the normal course of my duties. Originally the forms and papers on which we had to make out a case of this kind were made at the zone level. They would have to clear my office for my signature.

Q. They had the same problems in 1950 that you envisioned back there in 1948 such as raising additional capital to meet the minimum requirements in 1950, did they not?

A. That's right.

Q. But it was still approved by Chevrolet Division?

A. That's right. We give them a reasonable length of time to set up the standard, and then we

(Deposition of John Lester Connell.)

give them a year from the date the standard is written to meet that standard.

Q. But you did approve the splitting between Mr. Phelps and Mr. Kenyon in 1950?

A. That's right.

Q. I understood on your direct testimony that you differentiated between the selling agreement and a contract.

A. I should have never used the word "contract." There is no such thing.

Q. Don't you consider the selling agreement a contract? A. No, sir.

Q. Would you elucidate?

A. General Motors has always contended in all court procedures that we have no such thing as a contract. It is an agreement drawn up and signed by the zone manager and the dealer in which we agree to do certain things and the dealer agrees to do certain things. It has never been held in any court that it is a contract. It is a selling agreement.

Q. It has been in the courts, do you know?

A. Oh, yes. This is my own opinion, but my understanding is that it has been through all the courts and has been held that it is not a contract. I am giving that as my own personal understanding.

Q. It is a gentleman's agreement, more or less?

A. That's right, and I misused the word when I said "contract."

Q. Isn't it a fact, Mr. Connell, that General Motors, the top officials of General Motors, issued

(Deposition of John Lester Connell.)

instructions to their various branch managers not to give opinions or references to the methods to be employed in eliminating these trusts and holding companies from ownerships in these agencies?

A. I didn't give any opinion or suggestion as to how it might be eliminated.

Q. Was that not the policy of General Motors that no opinions or references be given?

A. I was never cognizant of that fact, although it was just good business that it was not our business. We referred them to their own legal counsel.

Mr. Townsend: That is all.

#### Redirect Examination

Q. (By Mr. Aikens): Mr. Connell, as I understand your testimony, you have testified that you suggested to Mr. Phelps that after the retirement of the trust and holding company, you wanted the balance of stock control in each of the three corporations to remain the same as it was before the retirement of the trust and holding company, is that correct?

A. That is what I thought I stated in my original testimony.

Q. Did you make this suggestion merely as a personal acquaintance or friend of Mr. Phelps or as the Regional Manager of the Chevrolet Motor Division charged with the responsibility of successful operations in the three dealerships that I mentioned here today?

A. Well, certainly it was not made as a friend of Norm Phelps or for any benefit he might accrue

(Deposition of John Lester Connell.)

from it, because it would have been, I think, the reverse. I felt the dealerships should remain on the same percentage basis. It wasn't that I ordered it as such. It was my suggestion that it be kept that way, because the operations were going along well. Everything was seemingly in good shape, and it would be forcing one of the partners out of the business. It would have put a man in a position of having to raise the money to meet our capital requirements. I am merely supposing now. It wasn't in my mind at that time of anything of a personal nature. It was purely that I felt that the business should be kept on the same basis as it was, and we were asking them to meet one of our policies by removing the trust and holding company interest. It was strictly a business decision on my part, and good or bad that was my decision at that time, and I felt it was to the best interest of our company and dealerships.

Q. But you made that suggestion as the Regional Manager of the Chevrolet Motor Division, which position you held at that time?

A. That's right.

Mr. Aikens: Those are all the questions that I have.

Mr. Thayer: May it be stipulated that the deposition may be signed before any notary public and further that whether it be signed or unsigned, it may be used for the same manner and the same purpose and place and for the same intents and purposes as it would be if it were signed?

Mr. Townsend: So stipulated.



Mr. Aikens: So stipulated.

Mr. Thayer: May it be further stipulated that this deposition may be introduced in evidence at the hearing set for September 12, 1955, at Los Angeles, California? May it be further stipulated that the reporter may serve copies on the parties without the necessity of sending them to the Tax Court?

Mr. Townsend: So stipulated.

Mr. Aikens: So stipulated.

(The deposition was closed at 2:00 p.m.)

The undersigned certifies that he has read the foregoing testimony adduced at the place and on the date shown in the above-entitled cause; that the 23 pages of testimony constitute a full, true and correct transcription of said testimony; and that changes, alterations or modifications, if any, have been noted by the notary public, at my suggestion, and initialed by me in each instance.

September 7, California, Los Angeles, 1955.

/s/ JOHN LESTER CONNELL,  
Deponent

[Endorsed]: T.C.U.S. Filed Sept. 12, 1955.

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[Title of Tax Court and Causes.]

## STIPULATION TO TAKE DEPOSITION

It Is Hereby Stipulated and Agreed by and between the parties hereto by their respective counsel of record that the testimony of James A. Kenyon,

a witness on the part of the petitioners, whose address is Apartado 174, Acapulco, Gro. Mexico, be taken at 3:00 p.m. o'clock on September 8, 1955 at 1104 Pacific Mutual Building, 523 West 6th Street, Los Angeles 14, California, before Helen D. Wilson, a notary public in and for the County of Los Angeles, State of California, and that if said deposition is not completed on said day it will be continued from time to time thereafter until completed; that said deposition and testimony, when taken, may be read and used in evidence in said cause on any trial thereof or in any proceeding therein, subject to the same objections and exceptions as if said witness were personally present, but without objection or exception to the time, place and manner of taking the same, or to the form of the questions, unless noted at the time.

/s/ WELLMAN P. THAYER,  
Counsel for Petitioners, F. Norman Phelps, Alice Phelps and James A. Kenyon Trust, James A. Kenyon, Trustee.

/s/ CAMERON B. AIKENS,  
Counsel for Petitioners, Jackson Howell and Virginia Howell.

/s/ JOHN POTTS BARNES, REM  
Chief Counsel, Internal Revenue Service, Counsel for Respondent.

[Title of Tax Court and Causes.]

DEPOSITION OF JAMES A. KENYON

Room 1104, Pacific Mutual Building, 523 West Sixth Street, Los Angeles 14, California. Thursday, September 8, 1955.

Testimony for Petitioners

The parties met, pursuant to Stipulation, at 3:00 p.m. at the above time and place.

Present: Wellman P. Thayer, Esq., of Dempsey, Thayer, Deibert & Kumler, 523 West Sixth Street, Los Angeles 14, California, for Petitioners F. Norman Phelps and Alice Phelps and the James A. Kenyon Trust. Cameron B. Aikens, Esq., of Getz, Aikens & Manning, 6435 Wilshire Boulevard, Los Angeles 48, California, for Petitioners Jackson Howell and Virginia Howell. Mark Townsend, Esq., (Hon. John Potts Barnes, Esq., Chief Counsel, Internal Revenue Service) 1135 Subway Terminal Building, Los Angeles, California, for the Commissioner.

Proceedings

JAMES A. KENYON

called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

Direct Examination

Q. (By Mr. Thayer): Will you state your full name, please?

(Deposition of James A. Kenyon.)

A. James A. Kenyon.

Q. Mr. Kenyon, were you, during the entire year 1948, an officer of each of the three corporations Capitol Chevrolet Co., Mid-Valley Chevrolet Co., and Howell Chevrolet Co.?

A. I was.

Q. During the entire year 1948 were you the Trustee of the James A. Kenyon Trust?

A. I was.

Q. During the entire year 1948 were you the owner of all of the outstanding capital stock of the J. A. K. Co. corporation? A. I was.

Q. Mr. Kenyon, I show you six letters which have been marked Petitioners' Exhibits 27 through 32, both inclusive, and will ask you to examine them.

(The witness examined the documents.)

In your capacity as an officer of the three corporations, Howell Chevrolet Co., Mid-Valley Chevrolet Co., and Capitol Chevrolet Co., were you aware of the receipt of these six letters on or about the date they bear? A. I was.

Q. Did you, at any time during the year 1948, discuss with your attorney, Mr. Thomas R. Dempsey, the matter of removing the James A. Kenyon Trust and the J. A. K. Co. from ownership of stock in the three corporations, Capitol Chevrolet Co., Mid-Valley Chevrolet Co., and Howell Chevrolet Co. in order to comply with the demands made by Chevrolet Motor Division in the six letters marked Petitioners' Exhibits 26 through 32, both inclusive?

A. Yes, I did.

(Deposition of James A. Kenyon.)

Q. Did you at any time request Mr. Dempsey to advise you concerning a method, or methods, by which Chevrolet Motor Division's requirements, as set forth in these letters, could be accomplished?

A. I did.

Q. In your discussions with Mr. Dempsey, did you and he at any time discuss the possibility of you personally purchasing all of the stock of the three corporations which were owned by the Trust?

A. Yes, we did.

Q. Do you know of your own knowledge why such a purchase was not made?

A. Yes, I do.

Q. Why?

A. First, because I didn't have any money. Mr. Dempsey couldn't find the money for me to put that investment in to buy the stock.

Q. During the last four months of 1948 what did your assets consist of?

A. Outside of J. A. K. Co., I had a home in Palm Springs, maybe two or three thousand dollars in the bank.

Q. Would you say, then, that your total assets consisted of your stock in the J. A. K. Co., your Palm Springs home and the money in the bank?

A. It was.

Q. Did you sell that home during 1948 or any time shortly thereafter?

A. I sold the home in 1952.

Q. And how much did you receive for it?

A. \$22,500.

Q. In your discussions with Mr. Dempsey, did



(Deposition of James A. Kenyon.)

you and he at any time discuss the possibility of your eliminating the J. A. K. Co. ownership of stock in the three corporations by means of a liquidation?      A. Yes, we did.

Q. Do you know, of your own knowledge, why a liquidation of J. A. K. Co. was not accomplished during the year 1948?      A. Yes, I do.

Q. Why was it not accomplished?

A. As Mr. Dempsey explained to me, it would cost me some \$80,000 or \$90,000 in taxes to liquidate J. A. K. Co.; that the 1949 Revenue Law would probably allow me to liquidate with no tax.

Q. It has been stipulated that prior to December 1, 1948, the James A. Kenyon Trust owned 170 shares of stock in Capitol Chevrolet Co., 120 shares of stock in Howell Chevrolet Co., and 170 shares of stock in Mid-Valley Chevrolet Co. It has also been stipulated that on December 21, 1948 Capitol Chevrolet Co. redeemed 130 of the Trust shares, Howell Chevrolet Co. redeemed 100 of the Trust shares, and Mid-Valley Chevrolet Co. redeemed 130 of the Trust shares. Do you know, of your own knowledge, why each of the three corporations did not redeem all of the Trust shares rather than merely a part of them?      A. Yes, I do.

Q. What was that reason?

A. The corporations wouldn't have had enough net working capital left to come within the financial standards of the Chevrolet Motor Company.

Q. By "financial standard" you mean the capital standard requirements?

A. Capital standards.

(Deposition of James A. Kenyon.)

Q. Following the redemption of a part of the Trust shares in each of the three companies on December 21, 1948, did you have any plan by which it was proposed to complete the removal of the Trust from its ownership of shares in the three corporations? A. Yes, I did.

Q. What was that plan?

A. Through this office we petitioned the court. Inasmuch as it was an irrevocable trust, we petitioned the court to allow me to purchase those extra shares of stock.

Q. And it was proposed that if that petition was granted, that you would make that purchase?

A. That I would make the purchase.

Mr. Thayer: That is all.

#### Cross Examination

Q. (By Mr. Townsend): Mr. Kenyon, during the year 1948 you received some \$90,000 combined salary from the three corporations. Why couldn't you use some of that money to purchase the stock, or rather, what happened to all that money in view of your net worth at the end of the year?

A. I would assume that I had most of that money tied up in the mortgage on the Calvada Lodge at Lake Tahoe in Nevada.

Q. Would you amplify somewhat on this mortgage you are referring to?

A. I had a friend that started to build the Calvada Lodge, and I financed him. He put up \$25,000, and I put up some, I think, \$15,000 to start with. Then he started to build it larger and

(Deposition of James A. Kenyon.)

larger, and I put in another \$10,000, another \$25,000, another \$30,000 over a period of that year and probably the next year until I had a total of \$85,000 invested.

Q. And in return for that investment you received a security mortgage on the lodge?

A. Mortgage on the property.

Q. Did you seek court approval when the corporations purchased the stock of the Trust?

A. I didn't understand you.

Q. Did you seek court approval when the corporations purchased the stock from the Trust?

A. No.

Q. Now, the Trust could have sold its stock to a third person other than yourself, could it not?

A. That is correct.

Q. Why did you not do that?

A. We would have had to take another partner in the business. He would have had to be approved by Chevrolet Motor Company, and I would have liked to keep the stock holdings equal.

Q. Now, after the liquidation of the corporations in 1950, did you continue your ownership in Mid-Valley Chevrolet Co.?

A. Yes, I did.

Q. In what form was the dealership continued? Was it a partnership or a corporation?

A. Partnership.

Q. And who were the other partners besides yourself? A. J. E. Carpenter.

Q. J. E. Carpenter and you? A. Yes.

Q. Was that an equal partnership?

(Deposition of James A. Kenyon.)

A. No. He had 25 per cent and I had 75 per cent.

Q. Did you have any agreement with Mr. Phelps as far as sharing the taxes which would result from the liquidation of the J. A. K. Co.

A. Yes, I did.

Q. And how was that arrangement?

A. Originally Phelps owned the J. A. K. Co. As to the date that I took it over, I don't recall. I traded him stock in the other companies for the J. A. K. Co., and he was to pay the stock up until the time that the stock was transferred into my name. I mean the taxes up until the stock was transferred into my name.

A. I see. So that if J. A. K. Co. was liquidated, then Mr. Phelps would also bear a share of the resultant tax?

A. He would have had to pay a portion of the tax.

Q. What was your intention, or what was the intention of the parties as you understood it, if you didn't get court approval to purchase the remaining Trust shares?

A. Then we were going to have the companies individually buy out the additional shares, and I was going to buy half of the shares from the individual, or rather in the case of Capitol, Phelps would buy out 40 shares, and I would, in turn, buy 20 shares from him. The same in Howell's case.

Q. The plan was for the corporation to buy the remaining shares of the corporation?

A. That's right.

(Deposition of James A. Kenyon.)

Q. I believe you stated in your direct testimony that the corporations did not redeem all the shares of the stock because it would then cause the working capital to fall below the minimum standards, as set by General Motors.

A. Correct.

Q. If only the shares of the Trust had been redeemed, would that have caused the corporations to fall below those minimum standards?

Mr. Thayer: I will stipulate that it would not.

The Witness: No.

Q. (By Mr. Townsend): What you meant by your answer on your direct examination, then, was that a combined redemption of the balance of the Trust shares, plus a corresponding pro rata redemption of the Phelps and Howell shares, would have caused the capital of the corporations to fall below the minimum capital standard requirements?

A. That is correct.

#### Redirect Examination

Q. (By Mr. Thayer): You spoke of loaning \$80,000 on a mortgage,—

A. No, I didn't. Wait a minute. Is that a question?

Q. —on a mortgage on property at Lake Tahoe. Do I understand from your answer to Mr. Townsend's question that you loaned \$80,000 of your funds to the mortgage on that property?

A. If I am not mistaken, my testimony says that we started off with \$25,000, and I put in \$15,000. Out of the \$80,000 I had to pay X income



(Deposition of James A. Kenyon.)

taxes to the Government, and X income taxes to the State. Right out of that \$80,000 I had to live. We started to build this business in Lake Tahoe. I think my first investment was \$5,000.

Q. Can you give the date of that?

A. My guess would be—no, I can't give you the exact date. I could if I had my records. My guess would be that it was in 1946 or 1947. As we put another part on to the building, or put in some more gambling tables, I had put in another \$10,000 into it and another \$10,000 until at the present time I now have \$85,000 in it, but it took a period of years to do it.

Q. Then, during the year 1948 you did not invest \$80,000 in that mortgage? A. No.

Q. During the year 1948 was the amount owing to you by the mortgagee \$80,000?

A. No, sir.

Q. Do you remember, approximately, how much it was?

A. Probably \$40,000, probably half of it.

Q. During the year 1948 were you indebted to anyone?

A. Outside of the United States Government, I don't think so.

Q. I call your attention to our retained office copy of your 1948 Federal income tax return and in particular to the item of interest deduction claimed in the amount of \$2,831.11. This return indicates that during the year 1948 you paid interest to General Motors Acceptance Corporation, Capital National Bank, Lincoln National Life Insurance

(Deposition of James A. Kenyon.)

Company, Northwestern Mutual Life Insurance Company, Irene Corwin. Does that refresh your recollection as to whether or not you were indebted to any of these persons?

A. Yes. Irene Corwin is my present wife. It seems to me that I put \$18,000 of her money into this Calvada Lodge. The life insurance interest was a straight loan that I had made some time prior to——

Q. Do you remember the approximate amount of the loan?

A. Again I would have to go to my records. It is very likely the General Motors Acceptance Corporation was for an automobile, but the \$1,000 to Capital National Bank and the two national life insurance companies at 6 per cent would figure some \$10,000 loan.

Q. On your cross examination I understood you to state that you had an agreement with Mr. Norman Phelps whereby he would share the tax on the liquidation of J. A. K. Co. Did I understand you correctly? A. That is correct.

Q. When J. A. K. Co. was liquidated in 1950, did Mr. Phelps pay any part of the tax on that liquidation?

A. Your office has the entire J. A. K. Co. review insofar as the transfer—the agreement drawn by your office where Phelps would pay part of the tax and the tax returns for J. A. K. Co.

Q. Then, it is your recollection that he did share in the tax on the liquidation?

A. I would assume he did.

(Deposition of James A. Kenyon.)

Mr. Thayer: That is all.

Recross Examination

Q. (By Mr. Townsend): What eventually happened to the remaining shares of the Trust stock?

A. Well, we liquidated it. Rather, when I sold my share of Capitol Chevrolet and Howell Chevrolet and the Trust Chevrolet, or the Trust to Phelps, and bought his share of Mid-Valley Chevrolet and Center Chevrolet at Colton, I invested the balance of the Trust in a mortgage on some real estate property again at Lake Tahoe.

Q. Well, then, the stock was sold to Mr. Phelps?

A. I bought all the stock that Mr. Phelps had in Mid-Valley Chevrolet at the book value of Mid-Valley Chevrolet at that time and sold to Mr. Phelps all of the stock which the Trust owned in Howell Chevrolet and Capitol Chevrolet at their book value.

Mr. Townsend: That is all.

Mr. Thayer: At this point I offer in evidence a photostatic copy of a retained office copy of the United States Federal Income Tax Return of James A. Kenyon for the year 1948 as Petitioners' Exhibit No. 37.

(The document above referred to was marked Petitioners' Exhibit No. 37 for identification and received in evidence.)

[See pages 191-3.]

Mr. Townsend: I have no objection.

Mr. Aikens: So stipulated.

Mr. Thayer: May we stipulate that the deposi-

(Deposition of James A. Kenyon.)

tion may be signed before any notary public and that whether it be signed or unsigned it may be used for the same manner and the same purpose and place and for the same intents and purposes as it would be if it were signed?

Mr. Townsend: I will stipulate to that.

Mr. Aikens: So stipulated.

Mr. Thayer: May we also stipulate that this deposition may be introduced in evidence at the hearing set for September 12, 1955 in Los Angeles, California? May we also stipulate that the reporter may serve copies on the parties without the necessity of sending them to the Tax Court?

Mr. Aikens: I will stipulate to that.

Mr. Townsend: So stipulated.

(The deposition was closed at 4:00 p.m.)

The undersigned certifies that he has read the foregoing testimony adduced at the place and on the date shown in the above-entitled cause; that the 18 pages of testimony constitute a full, true and correct transcription of said testimony; and that changes, alterations or modifications, if any, have been noted by the notary public, at my suggestion, and initialed by me in each instance.

Los Angeles, California, September 9, 1955.

/s/ JAS. A. KENYON,  
Deponent

[Endorsed]: T.C.U.S. Filed Sept. 12, 1955.



PETITIONERS' EXHIBIT 37  
INDIVIDUAL INCOME TAX RETURN

For calendar year 1948 or fiscal year beginning 1948, and ending 1948

EMPLOYEES: Instead of this form, you may use Form 1040A if your total income was less than \$3,000, consisting wholly of wages shown on Forms W-2, or of such wages and not more than \$100 of other wages, dividends, and interest.

Do not write in these spaces  
File  
Card  
Serial  
No.  
(Cashier's Stamp)

NAME James A. Kenyon  
(PLEASE PRINT. If this is a joint return of husband and wife, use first names of both)  
HOME ADDRESS 714 West Olympic Blvd. Room 75  
(PLEASE PRINT. Street and number or rural route)  
Los Angeles 15 Calif  
(City, town, or post office) (Postal zone number) (State)  
Occupation Auto dealer Social Security No. 165-10-2792

Your  
exempt-  
ions

1. List your own name.  
If married (did your wife (or husband) had no income, or if this is a joint return of husband and wife, list name of your wife (or husband)).

Name (please print)	Check below whether you (or your wife) were at the end of your taxable year—		On lines a and b below— Write 1 if neither 65 nor blind; Write 2 if either 65 or blind; Write 3 if both 65 and blind.
	65 OR OVER	BLIND	
YOUR NAME <u>James A. Kenyon</u>	Yes <input type="checkbox"/> No <input checked="" type="checkbox"/>	Yes <input type="checkbox"/> No <input checked="" type="checkbox"/>	a. Number of exemptions for you <u>1</u>
Wife's (or husband's) name <u>Mary H. Brown</u>	Yes <input type="checkbox"/> No <input type="checkbox"/>	Yes <input type="checkbox"/> No <input type="checkbox"/>	b. Number of her (his) exemptions
Name of Other Dependent Relative <u>Mother</u>	Relationship <u>Mother</u>		Address—If different from yours

Your  
income

Enter here total number of exemptions claimed (yours and your wife's plus one for each dependent listed above) 2

2. Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1948, BEFORE PAY-ROLL DEDUCTIONS for taxes, dues, insurance, bonds, etc. Also enter amount of income tax withheld. Members of armed forces and persons claiming traveling or reimbursed expenses, see instructions.

Print Employer's Name	Where Employed (City and State)	Amount of Income Tax Withheld	Total Wages
<u>Schedule</u>			
Enter totals		<u>\$ 21,129 72</u>	<u>\$ 126,635 04</u>

How to  
figure  
your  
tax

3. Enter here the total amount of your dividends.

4. Enter here the total amount of your interest (including interest from Government obligations unless wholly exempt from taxation).

5. If you received any other income, give details on page 2 and enter the total here.

6. Add income shown in items 2, 3, 4, and 5, and enter the total here \$126,635 04

IF YOUR INCOME WAS LESS THAN \$3,000.—You may find your tax in the tax table on page 4. This table, which is provided by law, automatically allows about 10 percent of your total income for charitable contributions, interest, taxes, casualty losses, medical expenses, and miscellaneous expenses. If your expenditures and losses of these classes amount to more than 10 percent, it will usually be in your advantage to itemize them and compute your tax on page 3.

IF YOUR INCOME WAS \$3,000 OR MORE.—Disregard the tax table and compute your tax on page 3. You may either take a standard deduction or itemize your deductions, whichever is to your advantage.

HUSBAND AND WIFE.—To obtain benefits of self-income provisions, husband and wife must file a joint return. If husband and wife file separate returns, or one itemizes deductions, the other must also itemize deductions.

7. Enter your tax from table on page 4, or from line 18, page 3.

8. How much have you paid on your 1948 income tax?  
(A) Total tax in item 2, above (attach Original Forms W-2) \$ 21,129 72  
(B) By payments on 1948 Declaration of Estimated Tax

Enter total here \$ 21,129 72

9. If your tax (item 7) is larger than payments (item 8), enter BALANCE OF TAX DUE here \$ 42,187 15  
This balance of tax due must be paid in full with return.

10. If your payments (item 8) are larger than your tax (item 7), enter the OVERPAYMENT here \$  
Check (✓) whether you want this overpayment: Refunded to you ☐ or Credited on your 1949 adjusted tax ☐

Tax  
due or  
refund

If you filed a return for a prior year, what was the latest year? 1947  
To which Collector's office was it sent? 6th Calif  
To which Collector's office did you pay amount claimed in item 8 (B), above?

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been prepared by me and to the best of my knowledge and belief is a true, correct, and complete return.

(Signature of person, other than taxpayer, preparing this return) (Date)

Is your wife (or husband) making a separate return for 1948?  
If "Yes," write her (or his) name \_\_\_\_\_ (Yes or No)  
Collector's stamp: 10/15/48

(Name of firm or employer, if any)  
To ensure any benefits of self-income provisions, husband and wife must include all self-income, and BOTH MUST SIGN, even though only one has income





## Petitioners' Exhibit 37--(Continued)

JAMES A. KENYON1948IncomeSalaries and bonuses

Capitol Chevrolet Co.	Withheld 7,602.20	14,712.69
Mid-Valley Chevrolet Co.	6,198.70	39,406.46
Howell Chevrolet Co.	7,328.82	42,515.89

21,129.72126,635.04DeductionsContributions

Community chests, Red Cross,  
Churches and other organized  
Charities - estimated

1,000.00Interest

General Motors Acceptance Corp.  
Capitol National Bank,  
Lincoln National Life Ins. Co.  
and Northwestern Mut. Life Ins. Co.  
Irene Corwin

1,031.11

1,800.002,831.11Taxes

Real estate and personal property  
State and local sales taxes (estimated)  
Unemployment insurance

154.87

700.00

30.00

Total - State return

884.87

California income tax

972.771,857.64Other Deductions

Business traveling and entertainment  
not reimbursed, involving numerous  
trips between Los Angeles and  
Sacramento, San Bernardino, Glendale,  
Chicago and Detroit - estimated

6,000.00

Alimony paid to Matilde R. Kenyon

6,750.00

Attorney fees

1,766.8914,516.89









[Title of Tax Court and Causes.]

## TRANSCRIPT OF PROCEEDINGS

Court Room No. 9, United States Post Office and Court House Building, Los Angeles, California.  
Monday, September 12, 1955.

(Met, pursuant to notice, at 2 o'clock p.m.)

Before: Honorable Arnold Raum, Judge.

Appearances: Wellman P. Thayer, Esq., 523 West 6th St., Suite 1104, Los Angeles 14, Calif., appearing for and on behalf of F. Norman Phelps and James A. Kenyon Trust, Petitioners. Cameron B. Aikens, Esq., 6435 Wilshire Blvd., Los Angeles, Calif., appearing on behalf of Jackson and Virginia Howell, Petitioners. Mark Townsend, Esq., 1135 Subway Terminal Bldg., Los Angeles 13, Calif., appearing for and on behalf of Commissioner of Internal Revenue, the Respondent.

### Proceedings

The Clerk: Docket numbers 51216, 51265, and 51282, Jackson and Virginia Howell and associated cases.

Mr. Thayer: Wellman P. Thayer for Petitioners F. Norman and Alice Phelps, and for James A. Kenyon Trust, James A. Kenyon, Trustee.

Mr. Aikens: Cameron B. Aikens for the Petitioners Jackson Howell and Virginia Howell, Petitioners in docket number 51216.

Mr. Townsend: Mark Townsend for the Respondent.

Mr. Thayer: I would like to offer the written motion to consolidate these three cases for hearing and decision.

The Court: The motion will be received and the cases will be consolidated.

Opening Statement on behalf of Jackson and Virginia Howell and associated cases by Wellman P. Thayer.

Mr. Thayer: If the Court please, these three cases have been to a great extent stipulated. We have depositions of three people to offer this afternoon. It is merely a matter of getting the various things in evidence and one witness.

For a brief statement of the case, the deficiencies are deficiencies in income tax for the year 1948, in a total amount of some \$350,000 or more, and the deficiencies all arise out of the same transaction, and involve the same issue of law.

The transaction briefly is this. In 1946, three Chevrolet dealerships were incorporated, and their stock was issued. In the case of two of them, the Capitol Chevrolet and the Mid-Valley Company, to F. Norman Phelps and Alice Phelps, 50 per cent; to the James A. Kenyon Trust, 20 per cent; and to the JAK Corporation, a personal holding company, all of which stock was owned by James Kenyon, 30 per cent.

In the case of the third corporation, Howell Chevrolet Company, the stock was issued, one third

to Jackson Howell, one third to F. Norman Phelps and Alice Phelps, approximately 13.3 per cent to James A. Kenyon Trust, and 20 per cent to the JAK Co. Corporation, the personal holding company. That was in the year 1946.

At the time the corporations were formed, the ownership of stock by a trust in the holding company was not objectionable to General Motors Corporation. In 1948, as the record will show, General Motors Corporation adopted a new policy by which neither a trust nor a holding company was to be permitted to own stock in any Chevrolet dealership. As a result of this policy, General Motors demanded that the trust and holding company be removed from ownership of stock in the three corporations, and it was suggested by the Regional Manager for Chevrolet Motor Division of the Pacific Region that the takeout, if you may call it that, of the trust and the personal holding company from the corporation be made in such a manner as to not to disturb the relative control of the Phelps, Kenyon, and Howell shares. In other words, to make the takeout in such a manner that after it was completed, Mr. Kenyon and Mr. Phelps would equally control the capital in Mid-Valley dealerships and Mr. Kenyon, Mr. Howell, and Mr. Phelps would equally control one third each of the Howell dealership.

As the result of the General Motors demand that this be done, the Capitol Chevrolet Company and Mid-Valley Chevrolet Company redeemed about 77 per cent of the shares owned by the James A. Ken-

yon Trust and the Howell Chevrolet Company redeemed about 83 per cent of the stock owned by the trust, and in order to continue this ratio of control, at the same time had redeemed about 30 per cent of the Phelps shares and about 33 per cent of the Howell shares. The Respondent—

The Court: What happened to the remaining shares of the trust that were not redeemed?

Mr. Thayer: As the record will show, Your Honor, it was impossible, because of the Capital Standards Provisions established by General Motors and Chevrolet Motor Company to take out all of the trust shares at the same time because it would reduce the working capital of the companies below the minimum requirements. Therefore, it was planned that the balance of the trust shares would be taken out by a direct purchase by Mr. Kenyon from the trust, but being trustee, he had to get Court approval for the purchase.

An action was filed in 1949 for him to make the purchase. It dragged along because of the inability to secure—there were many minors involved—it dragged along until 1950 when the question became mute because the Capitol Chevrolet Company bought out the entire Kenyon interests; the Mid-Valley Chevrolet Company bought out the Phelps interest, and the Howell bought on it. They all went out at the same time, but it was always intended that the trusts be taken out 100 per cent. It had to be done in two bites, however.

The Respondent's contention is that the redemption of these shares constituted an ordinary divi-

dend to all three of the Petitioners. It is the Petitioners' position that by reason of the fact that the takeout was occasioned by demand of General Motors Corporation, that there was a valid business purpose behind it, and that redetermination was not made at such a time or in such a manner as to be essentially to the taxable dividend.

In the case of Jackson and Virginia Howell, there is one minor issue on the compensation. The facts have been stipulated on that so that it would become mute, having found the fact that the compensation received, the taxability follows. There is no issue involved in that matter.

We have taken the depositions of three people, Mr. F. Norman Phelps, one of the Petitioners and also one of the key witnesses; the deposition of Mr. John Lester Connell, the Regional Manager of the Chevrolet Motor Division for the Pacific Region in 1948; and the deposition of James A. Kenyon, the trustee of the James A. Kenyon Trust, and the owner of all the stock in the JAK Co.

At this time, on behalf of the Petitioners, I would like to offer in evidence the direct and redirect testimony of the three men whose depositions have been taken. I offer it, subject to the objections made by the Respondent at the time the depositions were taken.

Mr. Townsend: Your Honor, the Respondent at this time will also offer the cross-examination and renew its objections to the direct and redirect of the Petitioner.

The Court: I don't quite understand what the



objections are. Are they objections that go to the entire deposition or specific questions?

Mr. Thayer: There are three specific questions. That is one thing we wanted to ask Your Honor today. Do you want those objections argued now or leave that for the briefs?

The Court: What is the general character of the objections?

Mr. Thayer: In the case——

Mr. Townsend: I may say, Your Honor, that Respondent will undoubtedly not renew all the objections made but just some of them.

Mr. Thayer: Actually, I think in each case, it is merely an objection because it would require a conclusion of the witness.

Mr. Townsend: I believe it is a hearsay one in there and a conclusion. Strictly on evidence, Your Honor, hearsay and conclusion.

The Court: I will receive the depositions, and I will consider only such objections as Respondent renews in his brief.

Mr. Thayer: That is the same for the Petitioner?

The Court: For both. If the parties can get together to eliminate all objections, it will be even more desirable.

Mr. Thayer: As a matter of fact, they are very minor. I know I couldn't get together on Mr. Townsend's objection on one minor one of his. I think the briefs would be the better place to renew it and argue the point.

The Court: I will consider only such objections as are renewed in the briefs.

Mr. Thayer: And the depositions are acceptable?

The Court: They are acceptable.

Mr. Thayer: At this time, I would like also to offer on behalf of the Petitioners a stipulation of facts which has been signed by both the Petitioners' counsel and the Respondent, counsel for the Respondent.

The Court: The stipulation will be received.

Mr. Thayer: Now, I think that Mr. Cameron Aikens, counsel for Jackson and Virginia Howell, would at this time like to put Mr. Howell on the stand. Oh, excuse me—In addition to the stipulations of fact, we have a number of joint exhibits, all of which are referred to in the stipulation. They begin with exhibit 1-A and run through exhibit 23-X, with the exception that exhibit 13, one of the letter combinations is inadvertently misstated on these exhibits. There is an exhibit 16-P and exhibit 17-R; through inadvertence, Q was omitted. All the exhibits are here, but they have been misnumbered to that extent. Does the Court wish to have that numbering changed to conform to the rules?

The Court: You may leave them as they are. I will receive the exhibits as part of the stipulation.

Mr. Thayer: As part of the stipulation.

Opening Statement on behalf of the Commissioner of Internal Revenue by Mark Townsend.

Mr. Townsend: If the Court please, this pro-

ceeding involves deficiencies in income tax for the taxable year 1948 in the following amounts. Jackson Howell and Virginia Howell, \$20,957.40; F. Norman Phelps and Alice Phelps, \$107,926.06; James A. Kenyon Trust, \$96,057.27. In addition, a deficiency for 1949 in the case of Mr. and Mrs. Howell only in the amount of \$2,729.16.

As Mr. Thayer has indicated, there was one other adjustment which was not in issue which affects the taxability of Mr. and Mrs. Howell for 1948 and 1949. That issue has been settled and the settlement has been incorporated in the stipulation of facts. I may point out that that is in paragraph twenty-four of the stipulation of facts, as that paragraph would not appear to be material to this proceeding. The reason that twenty-four is in the stipulation is to take care of the settlement of that issue.

The issue involved in this case is whether amounts received by the Petitioners in exchange for stock and reported by them as long term capital gain constituted dividends under Section 115G of the Internal Revenue Code of 1939. It is the Respondent's contention that Section 115G applies. That the redemptions were essentially equivalent to dividends and that the amounts received should have been reported as ordinary income.

We are in substantial agreement on the facts, as Mr. Thayer stated in his opening statement. I may point out, we are somewhat at disagreement on whether or not it was actual General Motors policy

that required this keeping of equal interests among the shareholders. The effect of that suggestion, I might add, is in probable dispute between the parties. Further, with respect——

The Court: I suppose the question is as far as these Petitioners are concerned, is not whether or not it was General Motors policy, but whether they reasonably thought it was.

Mr. Townsend: That is right.

Mr. Aikens: On behalf of the Petitioners' Howell, that is exactly our position.

Mr. Townsend: Now, with respect to the Petitioners' contention that a business purpose existed for this redetermination, namely, the policy of General Motors, to keep these interests the same and that a holding company and trust be eliminated, it is Respondent's position that this professed business purpose was used as a cloak to distribute accumulated surpluses in the business of Capital gains.

The Court: Is this case somewhere in between the Cartier-Tiffany case and the Boyle case?

Mr. Thayer: I think, if the Court please, I think this is very akin to the Smith case. There is really, in a sense, we had a compulsion for what we did, a very real one, and the Court will find from the record business pressure to do what we did in the manner in which we did it. I think it is the Smith case.

Mr. Townsend: Your Honor, Respondent does rely on several cases, but would prefer to wait to go into them on my brief, if I may.

Mr. Aikens: May I say, may it please the Court and counsel, that I believe I have read all the cases in this type of transaction. I will be frank to admit that I know of no one case that is on all fours with this particular one. The position of the Petitioners' Howell is briefly that there was a compelling business necessity so far as Jackson Howell was concerned in this transaction. If there wasn't, in fact, a compelling business necessity based upon his experience and knowledge, he had every reason to believe that it was a compelling business necessity.

May I call the witness, Jackson Howell.

Whereupon,

#### JACKSON HOWELL

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name and address, please.

The Witness: My name is Jackson Howell, 3342 Via Lido, Newport Beach, California.

#### Direct Examination

Q. (By Mr. Aikens): You are one and the same Jackson Howell named as a Petitioner in the case of Jackson Howell and Virginia Howell, Petitioners, versus Commissioner of Internal Revenue, bearing docket 51216, are you?      A. I am.

Q. What is your present capacity with Howell Chevrolet Company?

A. President and sole stockholder of Howell Chevrolet Company.



(Testimony of Jackson Howell.)

Q. Will you please tell the Court, commencing chronologically, your background with the General Motors Corporation, or any or all of its subsidiaries.

A. I was first employed by the General Motors Acceptance Corporation in Los Angeles in 1929 as their Special Collection Department Manager. Subsequently, for the next number of years, I was continuously employed by them in various capacities, from Special Collection Manager to Credit Manager to Field Manager, and in 1931, to Branch Manager of their operation in San Diego, until in the early part of 1933, I was transferred to the Chevrolet Motor Division of the General Motors Sales Corporation.

My first position at that time was that of District Manager. Subsequently, I held the position of Organization Manager in Los Angeles, Assistant Zone Manager in Los Angeles, Branch Manager in Great Falls, Montana, Branch Manager at Oakland, California, and in the latter part of '41, Assistant Regional Manager at Oakland, California.

In 1944, I left the Chevrolet Motor Division to become the Chevrolet Dealer at Glendale, California.

Q. You are presently the Chevrolet dealer in Glendale, California? A. I am, sir.

Q. And have been since 1944?

A. Since 1944.

Mr. Aikens: Mr. Clerk, may I have the deposition of Mr. Phelps.

(Testimony of Jackson Howell.)

Mr. Thayer: At this point, Your Honor, if I may, I neglected to offer in evidence the exhibits which are appended to the depositions of Mr. F. Norman Phelps and James A. Kenyon. I would at this time like to offer those in evidence.

Mr. Townsend: No objection.

The Court: They will be regarded as admitted.

Q. (By Mr. Aikens): Mr. Howell, I wish to call your attention at this time to two photostatic copies of letters presumably on the letterhead of the Chevrolet Motor Division and for purposes of identification, they have been described as Petitioners' exhibit 31 and Petitioners' exhibit 32, appended as an exhibit to the depositions of F. Norman Phelps, and I ask you whether or not you are familiar with the contents of those letters.

A. Yes, I am.

Q. Based upon your extensive experience with the General Motors Corporation and as an executive or former executive of the Chevrolet Motor Division of General Motors Corporation, what would your reaction have been had you received those letters on or about the date thereof?

A. Well, in November of 1948, in southern California and pretty generally across the country, Chevrolet franchises were regarded as being a valuable franchise. It is a year to year proposition. Had I received this letter, signed by the Zone Manager, I would have felt most definitely that I would have to comply with the request as set forth in the letter, and in my mind, I most definitely

(Testimony of Jackson Howell.)

would have felt that my franchise would be in jeopardy had I not followed it, the request in this letter, by the factory either not having renewed the selling agreement for the following year or possibly by a cancellation.

Q. For the purposes of the record, you are presently looking at Petitioners' exhibit 31?

A. 31.

Q. Would your answer be the same as you have just given with respect to Petitioners' exhibit 32-A?

A. It certainly would, yes, sir.

Mr. Aikens: Mr. Clerk, may I have the deposition of Mr. Connell.

Q. (By Mr. Aikens): You have heard today that the deposition of John Lester Connell has been introduced into evidence, subject to certain objections that were there taken or later after taken. Are you familiar or do you know a man by the name of John Lester Connell?

A. Yes, I do.

Q. Do you know what position he held with the Chevrolet Motor Division of the General Motors Corporation during the year 1948?

A. Mr. Connell was the Regional Manager for the Chevrolet Motor Division for the Pacific Coast Region. His office is located in Oakland, California.

Q. Have you read, Mr. Howell, the deposition given by John Lester Connell in these proceedings?

A. Yes, I just read it this morning.

Q. Have these same suggestions been made to you by Mr. Connell that Mr. Connell testified that

(Testimony of Jackson Howell.)

he made to Mr. F. Norman Phelps? And as a Chevrolet dealer, what would your reaction have been?

Mr. Townsend: The Respondent objects to that question on the grounds that it calls for a conclusion of this witness. It is based on a hypothetical question, and I don't believe this witness has been qualified to answer it.

Mr. Aikens: May it please the Court and counsel, I suggest that an adequate foundation has been laid of many years of participating as an employee and as an executive of the General Motors Corporation. We have likewise laid the foundation that the witness has been a Chevrolet dealer since 1944, approximately. He has read the deposition taken, The question, whether it be framed hypothetically or otherwise, I submit is a good one.

The Court: You may answer.

A. I would have felt exactly the same way about Mr. Connell's requests as indicated in his deposition that I have indicated in response to the exhibits 32 and 32. Most emphatically, that a request coming from the Regional Manager of the Chevrolet Motor Division in 1948 to a dealer in my opinion meant comply with it or be cancelled.

Q. (By Mr. Aikens): Directing your attention again back to the year of 1948, it has been stipulated that your compensation from Howell Chevrolet amounted to \$50,690.89 in 1948, and \$48,752.25 in 1949. Did you have in 1948 or 1949 any personal desire or personal reasons to draw money

(Testimony of Jackson Howell.)

from Howell Chevrolet in excess of the amounts that you drew as compensation?

A. No, there was no necessity for it as far as I was personally concerned. I had no occasion to need any more money. As a matter of fact, the withdrawal of the money in the manner in which it was taken out, in my opinion, placed a hardship on the operation of Howell Chevrolet for the simple reason that subsequent to the liquidation of this trust, it was necessary for Howell Chevrolet to borrow money on inventories which had not been the case prior to the taking out of the trust, and the holding company.

Mr. Aikens: If the Court has no further questions, I am finished with the direct.

### Cross Examination

Q. (By Mr. Townsend): Mr. Howell, how did you learn of the suggestions by Mr. Connell? Were they made to you at all?

A. No, they were not.

Q. When did you first learn of them?

A. I first learned of them from a telephone call from Mr. Phelps about the time the trust and the holding company was taken out. I was told to issue checks on certain amounts and that is the first I knew of it. Mr. Phelps had the contract at that time with the factory organization.

Q. Well, referring specifically now to the suggestion of Mr. Connell that the stock proportionate



(Testimony of Jackson Howell.)

ownership remain the same, you learned that information from Mr. Phelps?

A. That is correct.

Q. You don't know in what manner it was given or anything else?

A. Only from reading—subsequently reading his deposition.

Q. Mr. Howell, what part did you play in this redetermination of stock? Did you play any personal part?

A. No, I did not. Let me understand it. What do you mean?

Q. In the formulating of the plans or the manner in which it was accomplished.

A. No, I did not. As I mentioned, the first I knew about it was after the die was cast. I was told to issue the checks.

Q. After the plan had been adopted?

A. Subsequently.

Q. You did not vote yes or no yourself or have an opportunity to vote?

A. No, I did not.

Mr. Townsend: That is all.

The Court: The suggestion of General Motors could have been accomplished, could it not, by having the corporation redeem the trust shares and then having the remaining stockholders just purchase additional shares from the corporation to equalize the desired proportion.

(Testimony of Jackson Howell.)

The Witness: Subsequently, I think it was discussed, although I wasn't present. I think it was discussed. I think the difficulty at the time was that Kenyon, who had the trust and the holding company, didn't have the cash money to come up with in a sufficient quantity to maintain that balance.

The Court: Were the activities of the corporation in any way curtailed as a result of any re-determinations?

The Witness: They, in reality, were. We were operating on the basis of it carrying a good percentage of our own paper and with our inventories free and clear, without being encumbered—I am speaking now in the instance of Howell Chevrolet and immediately after this distribution or the taking out of the holding company and the trust—it wasn't noticeable for the simple reason that we were approaching the year end when the inventories were low, but as the succeeding months went by, we got into our selling period, February and March and April, and then we had to go out and borrow money against our inventories which would not have been necessary had the money remained in. We had to pay interest as a result of it, whereas, previously, we carried our own inventories.

The Court: You didn't curtail any of your operations as a result of liquidations. You tried to sell as many cars as you could get.

The Witness: That is right, but from my stand-

(Testimony of Jackson Howell.)

point as the operator of Howell Chevrolet and the President of the Howell Chevrolet, we would have been, in my opinion, much better off had those funds remained in the business.

Mr. Aikens: No further questions.

Mr. Townsend: The Respondent rests.

Mr. Thayer: That is all, Your Honor.

What is your Honor's wish as to briefs?

The Court: Do the Petitioners have any further evidence to present?

Mr. Thayer: The Petitioners rest.

Mr. Townsend: Rest.

Mr. Aikens: That is all for the Petitioners' Howell.

The Court: Do the Petitioners intend to file separate briefs or will they collaborate in a single brief?

Mr. Thayer: We will collaborate, Your Honor.

The Court: The Petitioners' brief will be due in forty-five days. The Respondent's in thirty days thereafter, and the Petitioners may reply in twenty days.

The case is dismissed.

(Whereupon, at 2:40 p.m., Monday, September 12, 1955, the hearing in this matter was closed.)

[Endorsed]: T.C.U.S. Filed October 26, 1955.

[Endorsed]: No. 15386. United States Court of Appeals for the Ninth Circuit. F. Norman Phelps and Alice Phelps, Petitioners, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed: December 11, 1956.

Docketed: December 17, 1956.

/s/ PAUL P. O'BRIEN,

Clerk of the United States Court of Appeals for the Ninth Circuit.

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In the United States Court of Appeals  
for the Ninth Circuit

Docket No. 15386

F. NORMAN PHELPS and ALICE PHELPS,  
Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Appellee.

STATEMENT OF POINTS ON WHICH AP-  
PELLANTS WILL RELY

1. The Tax Court of the United States erred in finding that the distributions made by the three corporations, Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. to appellants on December 21, 1948, in redemption of a part of appellants' shares in each of such corporations

were made at such time and in such manner as to be substantially equivalent to distributions of taxable dividends which are to be treated as taxable dividends as provided in Section 115(g) of the Internal Revenue Code of 1939.

2. The Tax Court of the United States erred in failing to find that the distributions in redemption of a part of appellants' shares in each of the three corporations, Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. which were made on December 21, 1948 were not made at such time or in such a manner as to be substantially equivalent to distributions of taxable dividends.

3. The Tax Court of the United States erred in failing to find that the amount received by each of the appellants from each of the three corporations, Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co., upon the redemption of their shares of stock in such corporations on December 21, 1948, constituted an amount received in partial liquidation of the respective corporation which is to be treated as in part or full payment in exchange for such corporation's shares as provided in Section 115(c) of the Internal Revenue Code of 1939.

4. The Tax Court of the United States erred in finding that the redemptions of the stock of the three corporations, Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co., which were made on December 21, 1948 caused the capital of each of said corporations to fall below the



standards set by the Chevrolet Motor Division of General Motors Corporation.

5. The Tax Court of the United States erred in finding that there is a deficiency in appellants' federal income taxes for the year 1948 in the amount of \$107,926.06.

/s/ W. P. THAYER,  
Attorney for Appellants

Acknowledgment of Service attached.

[Endorsed]: Filed January 8, 1957. Paul P. O'Brien, Clerk.



No. 15386

IN THE

United States Court of Appeals  
FOR THE NINTH CIRCUIT

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T. NORMAN PHELPS and ALICE PHELPS,

*Appellants,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,

*Appellee.*

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On Appeal From a Decision by the United States Tax Court.

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BRIEF FOR APPELLANTS.

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FILED

APR 12 1937

PAUL P. GIBNEY, CLERK.



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No. 15386  
IN THE  
**United States Court of Appeals**  
FOR THE NINTH CIRCUIT

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F. NORMAN PHELPS and ALICE PHELPS,

*Appellants,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,

*Appellee.*

---

On Appeal From a Decision by the United States Tax Court.

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**BRIEF FOR APPELLANTS.**

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**Jurisdictional Statement.**

By registered letter mailed on August 19, 1953, pursuant to Section 272 of the Internal Revenue Code of 1939 (26 U. S. C. 272) the Commissioner of Internal Revenue notified appellants of his determination of a deficiency of \$107,926.06 in their Federal income tax for the calendar year 1948. [R. 11.] Thereafter, on November 17, 1953, appellants filed with The Tax Court of the United States their petition for a redetermination of such deficiency [R. 3], and that Court properly assumed jurisdiction over the appeal pursuant to Section 1101 of the Internal Revenue Code of 1939 (26 U. S. C. 1101). On January 5, 1954, the Commissioner of Internal

Revenue filed his answer to appellants' petition and thereafter on September 12, 1955, a hearing was had in the matter before The Tax Court of the United States [R. 4.] Thereafter, on July 31, 1956, The Tax Court of the United States entered its decision in favor of the Commissioner. [R. 44.]

On October 25, 1956, and within the time required by Section 7483 of the Internal Revenue Code of 1954 (26 U. S. C. 7483) appellants filed with the Clerk of The Tax Court of the United States their petition for a review of said decision and served a copy and notice thereof upon the Commissioner of Internal Revenue as required by rule 29 of this Court. [R. 50.]

Appellants' income tax return for the calendar year 1948 was filed with the Collector of Internal Revenue for the 6th District of California whose office was located within the Ninth Judicial Circuit. Jurisdiction of this Court to review the decision of The United States Tax Court therefore exists by virtue of Section 7482 of the Internal Revenue Code of 1954. (26 U. S. C. 7482.)

### **Statement Concerning Exhibits Appearing in Appendix.**

In Appellants' designation of the record material to the consideration of the appeal, Appellants designated all of the exhibits which were attached to the Stipulation of Facts, excepting therefrom only certain pages of Joint Exhibits 9-I through 23-X, but upon receipt of their copies of the Transcript of Record counsel for Appellants noted that none of the exhibits attached to the stipulation

had been printed. Counsel thereupon wrote to the Clerk of the Court, pointing out the omission and the materiality of the exhibits and requesting advice as to the steps to be taken to have such exhibits included in the printed transcript. In reply to their inquiry the Clerk advised counsel that it is not the practice to print exhibits in the interest of economy and that the Court would examine the exhibits without the necessity of reproduction; but stated that if counsel wished they might print as an appendix to their brief the exhibits, or parts of exhibits, which they desired to call to the Court's attention.

Counsel have, therefore, included in the Appendix hereto each of the unprinted exhibits to which reference is made in this brief.

### **Statement of the Case.**

This case presents a single question for decision, namely:

Were the distributions which were made to appellants on December 21, 1948, in redemption of a part of their shares of stock in each of three corporations made at such a time and in such a manner as to be essentially equivalent to taxable dividends within the meaning of Section 115(g) of the Internal Revenue Code of 1939?

Appellants are husband and wife residing in Piedmont, California. They filed a joint income tax return for the year 1948 with the Collector of Internal Revenue for the 6th District of California. [R. 16, 17.]

On April 10, 1946, three corporations, namely Capitol Chevrolet Co., Mid-Valley Chevrolet Co., and Howell Chevrolet Co. were formed and from that date until December 21, 1948, all of the outstanding shares of stock of these corporations were owned as follows:

Shareholder	<u>Capitol Chevrolet Co.</u>	<u>Mid-Valley Chevrolet Co.</u>	<u>Howell Chevrolet Co.</u>
F. Norman Phelps (Appellant herein)	212 shares	213 shares	150 shares
Alice Phelps (Appellant herein)	213 "	212 "	150 "
James A. Kenyon, Trustee of Patricia May Kenyon Trust	170 "	170 "	120 "
J.A.K. Co.	255 "	255 "	180 "
Jackson Howell	—	—	300 "
TOTAL SHARES OUTSTANDING	850	850	900

[R. 17-19]

The Patricia May Kenyon Trust, one of the shareholders in each of the above-named corporations, was a trust which had been created on August 8, 1941 by James A. Kenyon for the benefit of his adopted daughter, Patricia May Kenyon. James A. Kenyon, the creator of this trust, was also the trustee thereof. [R. 17.]

The Patricia May Kenyon Trust was irrevocable and James A. Kenyon, the creator and trustee thereof, had no beneficial interest in the income or corpus thereof other than a remote possibility of reverter. [Jt. Ex. 4-D; Appendix pp. 22-30.]

J. A. K. Co., one of the shareholders in each of the above named corporations, was a corporation all of whose stock was owned by James A. Kenyon individually. J. A. K. Co. was a holding company and the shares of

stock of Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. constituted substantially all of its assets. [R. 24.]

James A. Kenyon, the creator and trustee of the Patricia May Kenyon Trust, was the same James A. Kenyon who owned all of the J. A. K. Co. stock. [R. 180.]

F. Norman Phelps, James A. Kenyon and Alice Phelps were President, Vice-President and Secretary-Treasurer, respectively, of Capitol Chevrolet Co. from the date of its incorporation to December 21, 1948. F. Norman Phelps, Joseph E. Carpenter and James A. Kenyon were President, Vice-President and Secretary-Treasurer, respectively, of Mid-Valley Chevrolet Co. during this same period, and Jackson Howell, F. Norman Phelps and James A. Kenyon were President, Vice-President and Secretary-Treasurer, respectively, of Howell Chevrolet Co. during this same period. [R. 19.]

During the twenty-five year period preceding the formation of the three dealership corporations, appellant F. Norman Phelps had been continuously employed by Chevrolet Motor Division of General Motors Corporation and during that period he had occupied successively the positions of Retail Salesman, Used Car Manager, Sales Manager, District Manager, Office Manager, Assistant Zone Manager, City Sales Manager, Zone Manager, Assistant Regional Manager, and finally Regional Manager for the Pacific Coast Region of Chevrolet Motor Division. [R. 54-55.] James A. Kenyon had practically the same background and experience with Chevrolet Motor Division as did Mr. Phelps [R. 89], and from 1933 through 1944, Jackson Howell had occupied successively the offices of District Manager, Organization Manager of Los Angeles, Assistant Zone Manager of Los Angeles, Branch



Manager in Great Falls, Montana, Branch Manager in Oakland, California, and Assistant Regional Manager at Oakland, California. [R. 205.]

Each of the corporations, Capitol Chevrolet Co., Mid-Valley Chevrolet Co., and Howell Chevrolet Co., was engaged in the business of operating a Chevrolet dealership under a separate "Annual Direct Dealer Selling Agreement" with the Chevrolet Motor Division of the General Motors Corporation. [R. 21.] Each of these dealerships was located within the Pacific Coast Region of Chevrolet Motor Division of General Motors Corporation. [R. 56.]

During the year 1948 the Pacific Coast Region of Chevrolet Motor Division was in the charge of J. L. Connell as Regional Manager thereof. [R. 57, 162.]

During the year 1948 Chevrolet Motor Division of General Motors Corporation established a new policy that no trust or holding company could own an interest in a Chevrolet dealership. [R. 163.] About September 1, 1948 Mr. J. L. Connell, in his capacity as Regional Manager of the Pacific Coast Region of Chevrolet Motor Division, called Mr. F. Norman Phelps to his office and advised him of the establishment of this new policy. Mr. Connell informed Mr. Phelps that steps should be taken to eliminate both the Patricia May Kenyon Trust and J. A. K. Co. from ownership of stock in each of the three dealership corporations and suggested that the elimination of the trust and holding company from such ownership be accomplished in a manner that the proportionate control of Messrs. Phelps, Kenyon and Howell in the three dealerships should remain unchanged. [R. 66, 166, 167.] Mr. Connell's suggestion that the relative control of these three men in the corporations should remain the

same was made as the result of a strictly business decision on his part, as Regional Manager, and arose out of his belief that it was to the best interests of both Chevrolet Motor Division and the dealerships that such relative controls be maintained. [R. 175, 176.]

Based upon his long experience as an employee of Chevrolet Motor Division, and particularly upon his experience as Regional Manager of the Pacific Coast Region, it was Mr. Phelps' firm belief, following his discussion with Mr. Connell that if any one of the three companies, Capitol Chevrolet Co., Mid-Valley Chevrolet Co., or Howell Chevrolet Co., failed to comply with the demand of General Motors that the Trust and holding company be removed from ownership of stock in those corporations, or if they failed to comply with the suggestion of Mr. Connell that such removal be accomplished in such a manner as not to disturb the then existing proportionate control of himself and Mr. Kenyon, then either the franchises of those corporations would not be renewed the next year or they would be cancelled. [R. 76, 77, 85, 86.] He also believed that if such cancellation occurred no other General Motors Corporation franchise would have been offered to, or available to, any of the companies. [R. 90.]

Following his discussion with Mr. Connell, Mr. Phelps informed Mr. Kenyon, who handled the three corporations' financial matters, of his conversation with Mr. Connell regarding what had to be done in complying with the new requirements and suggested that Mr. Kenyon get in touch with Mr. Thomas R. Dempsey, attorney for the three corporations, and ask him to work out some plan by which those requirements could be met. [R. 68, 69.]

Mr. Kenyon and Mr. Dempsey discussed the matter of liquidating J. A. K. Co. in order to comply with Chevrolet

Motor Division's requirements that this holding company be eliminated from ownership in the dealerships, but Mr. Dempsey recommended against such a liquidation during the year 1948 for the reason that such a liquidation would cost Mr. Kenyon from eighty to ninety thousand dollars in taxes, whereas if it were postponed until the Revenue Act of 1949 were passed the liquidation might be accompanied tax free. [R. 182.]

Mr. Kenyon and Mr. Dempsey also discussed ways and means by which the Trust could be removed from ownership of stock in the three corporations in order to comply with Chevrolet Motor Division's requirements. In the course of such discussions they considered the possibility of Mr. Kenyon personally purchasing all of the stock of the three corporations which was owned by the Trust. [R. 181.] Such a purchase, however, was impossible for the reason that Mr. Kenyon's only assets at the time consisted of his stock in J. A. K. Co., a home in Palm Springs and two or three thousand dollars in the bank. [R. 181.] Mr. Kenyon and Mr. Dempsey also considered the possibility of having the three corporations redeem only the Trust shares and then having Mr. Kenyon purchase additional shares from the corporation to equalize the desired proportion; but this could not be done because Mr. Kenyon did not have sufficient cash to make the required purchase. [R. 210-211.]

Following the initial discussions between Mr. Kenyon and Mr. Dempsey and as the result of the problems which developed in the course of such discussions Mr. Phelps, on October 16, 1956, wrote the following letter to Mr. A. W. Strang, the Zone Manager of the Oakland Zone of the Pacific Coast Region of Chevrolet Motor Division, the zone within which the Capitol Chevrolet Co. dealership was located [R. 155]:

“October 16, 1948

“Mr. A. W. Strang

Chevrolet-Oakland

10910 East 14th Street, Oakland 4, California

Dear Art:

Mr. DeLong and I had a conference concerning our situation after the Contracting Meeting here in Sacramento last Monday; then on Wednesday Mr. DeLong called and asked that I give you the information concerning our setup as I gave it to him verbally.

You will remember that previously I informed you we would do anything that Chevrolet Motor Company required concerning our capital structure, and inasmuch as the Division wishes us to eliminate the Trust and the Holding Company, I informed you we would arrange to do this.

As you know, the J. A. K. Co., which is a Nevada Corporation owned by James A. Kenyon, now owns 30 per cent of the stock in Capitol Chevrolet Company, 30 per cent in Mid Valley Chevrolet, and 20 per cent in Howell Chevrolet. Our attorney advises that if this J. A. K. Co. were to be liquidated at the present time, the tax situation is such that Mr. Kenyon and I would be subject to approximately \$90,000.00 tax.

It would seem that if it were possible for you to permit us to postpone the change until the Revenue Act of 1949 passes both the House and the Senate, it would be most helpful to us.

Also, the complications would be the same in the separation of the Center Chevrolet at Colton from Mid Valley Chevrolet in San Bernardino.

So in both instances it unquestionably would work a hardship on us to make the changes at the present time—and if at all possible we would like to wait and see if this new tax bill is passed. It is my understanding that it passed the House at the last session, but was buried in the Senate due to the great number of Bills in the closing days of the session.

At the present time we are working on a way to buy out the Trust by the different corporations. We believe this can be handled because although it is an irrevocable Trust, Mr. Kenyon has jurisdiction over the Trust until his daughter becomes of age.

In eliminating both the Trust and the Holding Company, it may be necessary to reduce our Net Working Capital substantially, and this might result in our being undercapitalized according to the established standard requirements.

We will give you a detailed report as to just what we would like to do in the very near future, at which time I will come to your office and explain the entire transaction in detail. I would appreciate very much having Mr. Connell sit in on this discussion because, as you know, the deals in Southern California are also involved.

Because of the complications, I would appreciate Chevrolet Motor Division giving us six months or a year to work out of the seeming difficulties with which we are faced at the present time.

Very truly yours,

F. Norman Phelps, President

cc—Mr. J. L. Connell, Mr. Gus Culbertson,

Mr. J. A. Kenyon

FNP:ns.”



In addition to writing the foregoing letter Mr. Phelps also discussed the matter with Mr. J. L. Connell, the Regional Manager, and asked him whether or not it would be satisfactory if the liquidation of J. A. K. Co. were delayed until the new law was passed [R. 74], and it was agreed by Mr. Connell that some extension would be given. [R. 166.]

On November 1, 1948, concurrently with the delivery of each of the three corporations of the new "Annual Direct Dealer Selling Agreement" for the period commencing on that date, each of the corporations received two letters from Chevrolet Motor Division. One of these letters notified the company that its operations were unsatisfactory in that all or a part of the ownership in the dealership was held by a trust and the other of the letters advised the company that its operations were unsatisfactory in that all or a part of the ownership in the dealership was held by a holding company. [R. 143-152.] These letters were sent by Chevrolet Motor Division in conformance with its new policy above mentioned. [R. 164.]

If the companies had failed to comply with the requirements set forth in the letters of Chevrolet Motor Division dated November 1, 1948, they would have been sent another letter in which they would be told a new Selling Agreement was not being offered because they were not complying with the policy of the company. [R. 168.]

The plan which was finally adopted to meet the requirements of Chevrolet Motor Division with respect to the elimination of the Trust as a shareholder in the three corporations was one formulated by Mr. Dempsey, the attorney for the three corporations. [R. 71.] Mr. Phelps

had no knowledge of the details of this plan prior to the time when Mr. Dempsey sent him proposed minutes to be adopted at meetings of the Board of Directors of the three corporations [R. 71] and Mr. Jackson Howell, the owner of one-third of the stock of Howell Chevrolet Co. had no knowledge of the details of the plan until after it had been adopted. [R. 210.] Mr. Howell did not vote and did not have an opportunity to vote on the adoption of the plan. [R. 210.]

The plan which was formulated by Mr. Dempsey and finally adopted had two separate steps:

**Step 1.**

(a) The purchase by each of the respective corporations from the Trust of the maximum possible number of its Trust-owned shares, and

(b) The purchase by each of the respective corporations from F. Norman Phelps and Alice Phelps, and the purchase by Howell Chevrolet Co. from Jackson Howell, of such a number of shares that, after the accomplishment of Step 2, the Phelps-Kenyon\* control in Capitol Chevrolet Co. would remain at 50% each and the Phelps-Kenyon\*-Howell control in Howell Chevrolet Co. would remain at 33⅓%. (\*Through J. A. K. Co.)

**Step 2.**

The purchase by James Kenyon, personally, of the balance of shares owned by the Trust in each of the three corporations which were not to be purchased in Step 1.

The second step in the plan was expressly conditioned on the ability of Mr. James Kenyon to secure court authority for his purchase of the stock from the Trust;

and, as an alternative to be used in the event the Court should fail to authorize such purchase, the plan provided that each of the three companies would purchase the balance of its shares which were owned by the Trust. [Jt. Exs. 5-E, 6-F, 7-G; Appendix pp. 31-48.]

The plan formulated by Mr. Dempsey did not call for the purchase by the three corporations of all of the stock held by the Trust in those corporations for the reason that if the purchase of all of the Trust's shares, and the purchase of the required corresponding number of Phelps and Howell shares, had been made by the corporations they would not have had sufficient net working capital left to comply with the Capital Standards requirements of Chevrolet Motor Division. [R. 182.]

Step 1 of the plan was consummated on December 21, 1948, when the three corporations, pursuant to resolutions of their respective boards of directors adopted on that day, distributed the following amounts of money to the following shareholders, respectively, in redemption of the number of their shares shown, to-wit [R. 19-20]:

*Capitol Chevrolet Co.*

<u>Shareholder</u>	<u>Amount Distributed</u>	<u>Shares Redeemed</u>
F. Norman Phelps	\$37,759.15	65
Alice Phelps	37,759.15	65
Patricia May Kenyon Trust	75,518.30	130

*Mid-Valley Chevrolet Co.*

F. Norman Phelps	37,170.25	65
Alice Phelps	37,170.25	65
Patricia May Kenyon Trust	73,340.50	130

*Howell Chevrolet Co.*

F. Norman Phelps	\$23,254.00	50
Alice Phelps	23,254.00	50
Patricia May Kenyon Trust	46,508.00	100
Jackson Howell	46,508.00	100

The consummation of Step 2 of the plan was commenced on June 1, 1949, by the filing by James A. Kenyon, as Trustee of the Patricia May Kenyon Trust, of a petition to the Superior Court of the State of California, in and for the County of Los Angeles, for an order to sell the remaining trust shares in the three corporations to himself as an individual. Proceedings in this action were continued until July, 1950, when the need for the order prayed for in the petition disappeared by reason of the sales of the remaining Trust stock in Capital Chevrolet Co. and Howell Chevrolet Co. to those corporations, respectively, and by the liquidation of Mid-Valley Chevrolet Co. [R. 21, 22.]

Neither Mr. nor Mrs. Phelps had any need for the money which was distributed to them in the redemption of their shares of stock in the three corporations; Mr. Phelps did not at any time request Mr. Dempsey to draw the plan for the elimination of the trust stock in such a manner that he or Mrs. Phelps would receive any cash or property out of the corporations or any of them; and Mr. Phelps at no time suggested to Mr. Dempsey that it would be a desirable feature of any plan which might be devised by him that either he or Mrs. Phelps would receive any cash or property from any of the corporations. [R. 77-78.]

Mr. Howell had no personal desire to draw any money from Howell Chevrolet Co. in excess of that which he drew as compensation, and it was his opinion that the withdrawal of funds from the Howell Chevrolet Co. in the manner in which it was taken out placed a hardship on the operations of the company because it made it necessary for the company to borrow money on its inventories. [R. 209.]

The three corporations' Capital Standards Agreements with Chevrolet Motor Division required them to attain by August 15, 1948, and maintain thereafter, Owned Net Working Capital in the amount of \$261,034.00 and Total Owned Capital in the amount of \$300,533.00. Failure to comply with these requirements constituted grounds for terminating their Chevrolet selling agreements. [R. 139.]

The amounts of Owned Net Working Capital and Total Owned Capital of the three corporations on the thirty-first day of December of the years 1946, 1947 and 1948 were, respectively, as follows:

<u>Corporation</u>	<u>Owned Net Working Capital</u>	<u>Total Owned Capital</u>
<i>December 31, 1946</i>		
Capitol Chevrolet Co.	\$130,207.19	\$160,299.01
Mid-Valley Chevrolet Co.	136,878.63	161,852.62
Howell Chevrolet Co.	106,419.84	154,342.56
[Jt. Exs. 19-T, p. 5; 14-N, p. 7; 9-I, p. 6; Appx. pp. 55; 52; 49]		
<i>December 31, 1947</i>		
Capitol Chevrolet Co.	284,993.47	325,856.62
Mid-Valley Chevrolet Co.	249,240.01	310,853.04
Howell Chevrolet Co.	161,890.95	287,643.74
[Jt. Exs. 20-U, p. 7; 15-O, p. 10; 10-J, p. 7; Appx. pp. 56; 53; 50]		
<i>December 31, 1948</i>		
Capitol Chevrolet Co.	281,782.24	344,666.90
Mid-Valley Chevrolet Co.	219,320.71	334,536.12
Howell Chevrolet Co.	199,773.96	283,970.73
[Jt. Exs. 21-V, p. 7; 16-P, p. 11; 11-K, p. 6; Appx. pp. 57; 54; 51]		

None of the three corporations paid any dividends to their shareholders during the period from the date of incorporation, April 10, 1946, to December 21, 1948. [R. 21.]



On their joint return for the calendar year ended December 31, 1948, appellants reported the amounts received by them from Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. in the redemption of their shares in those companies which had taken place on December 21, 1948, as amounts received from the sale or exchange of such shares and computed their taxes thereon in accordance with the provision of Section 115(c) of the Internal Revenue Code of 1939. In his notice of determination of the deficiency asserted against appellants for the year 1948 the Commissioner of Internal Revenue determined that the amounts so received by appellants were taxable as dividends under Section 115(g) of the Internal Revenue Code of 1939. This determination was affirmed by The Tax Court of the United States in the decision below.

### **Specification of Errors.**

1. The Tax Court of the United States erred in making the following finding of fact:

“Because of the fact that the shares of other stockholders were redeemed along with the trust shares, the capital of the corporations fell below the standards set by Chevrolet.” [R. 39.]

This finding is unsupported by any evidence and is directly contrary to the evidence in the case of Capitol Chevrolet Co.; it is supported, in part only, by the evidence and is, in part, directly contrary to the evidence in the case of Mid-Valley Chevrolet Co.; and is wholly supported by the evidence only in the case of Howell Chevrolet Co. However, even to the extent that the finding is supported in form by the evidence, it is unsupported in substance because of the circumstances of the case.

2. The Tax Court of the United States erred in finding that the distributions made by the three corporations, Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. to appellants on December 21, 1948, in redemption of a part of appellants' shares in each of such corporations were made at such time and in such manner as to be substantially equivalent to distributions of taxable dividends which are to be treated as taxable dividends as provided in Section 115(g) of the Internal Revenue Code of 1939.

3. The Tax Court of the United States erred in failing to find that the distributions in redemption of a part of appellants' shares in each of the three corporations, Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co. which were made on December 21, 1948, were not made at such time or in such a manner as to be substantially equivalent to distributions of taxable dividends.

4. The Tax Court of the United States erred in failing to find that the amount received by each of the appellants from each of the three corporations, Capitol Chevrolet Co., Mid-Valley Chevrolet Co. and Howell Chevrolet Co., upon the redemption of their shares of stock in such corporations on December 21, 1948, constituted an amount received in partial liquidation of the respective corporation which is to be treated as in part or full payment in exchange for such corporation's shares as provided in Section 115(c) of the Internal Revenue Code of 1939.

5. The Tax Court of the United States erred in finding that there is a deficiency in appellants' federal income taxes for the year 1948 in the amount of \$107,926.06.

## Summary of Argument.

### POINT I.

The Tax Court committed prejudicial error in finding as a fact that because of the fact that the shares of other stockholders were redeemed along with the trust shares, the capital of the corporations fell below the standards set by Chevrolet and made the corporations' dealership franchises subject to cancellation for cause.

### POINT II.

The distributions to appellants in redemption of a part of their shares in each of the three corporations were not essentially equivalent to distributions of taxable dividends for the reasons: (a) that the distributions were not made pro rata to all shareholders, (b) that the sole purpose of the distributions was a legitimate corporate purpose, and (c) the net effect of such distributions was entirely different from that of taxable dividends.

### POINT III.

The distributions to appellants in redemption of a part of their shares in each of the three corporations constituted amounts distributed in partial liquidation of the corporations and were properly reported by appellants on their return for the year 1948.

## POINT I.

The Tax Court Committed Prejudicial Error in Finding as a Fact That Because of the Fact That the Shares of Other Stockholders Were Redeemed Along With the Trust Shares, the Capital of the Corporations Fell Below the Standards Set by Chevrolet and Made the Corporations' Dealership Franchises Subject to Cancellation for Cause.

The finding of which counsel for Appellants complain is as follows:

"If only the shares of the trust had been redeemed by the three corporations, their capital would not have fallen below the capital standard requirements set by Chevrolet.

"Because of the fact that the shares of other stockholders were redeemed along with the trust shares, the capital of the corporations fell below the standards set by Chevrolet. The additional cash distributions to the other stockholders placed a hardship on the corporations by requiring them to borrow funds. Failure to meet the capital standard requirements is reason for termination of a dealer's franchise." [R. 39.]

Each of the three corporations was a party to a Capital Standards Agreement with Chevrolet Motor Division which required it to attain by August 15, 1948, and maintain thereafter Owned Net Working Capital and Total Owned Capital in the following amounts [R. 139]:

*Owned Net Working Capital*

\$261,034.00

*Total Owned Capital*

\$300,533.00

Under the Capital Standards Agreement Owned Net Working Capital was defined as being the excess of total current assets (cash, receivables, cars, parts, accessories,

prepaid expenses and all other inventories) over liabilities, and Total Owned Capital was defined as being Owned Net Working Capital plus fixed and deferred assets. [R. 138, 139.]

On December 31, 1948, and following the redemptions in question the respective Owned Net Working Capital and Total Owned Capital of the three corporations were as follows:

	Capitol Chevrolet Co. [Jt. Ex. 21-V, Appx. p. 57]	Mid-Valley Chevrolet Co. [Jt. Ex. 16-P, Appx. p. 54]	Howell Chevrolet Co. [Jt. Ex. 11-K, Appx. p. 51]
Cash	\$ 97,423.07	102,709.91	114,751.66
Receivables	242,157.67	157,734.44	160,264.68
Inventories	256,541.90	209,413.26	144,942.41
Total Current Assets	\$595,122.64	469,857.61	419,958.75
Liabilities	314,340.40	250,536.90	220,184.79
Owned Net Working Capital	281,782.24	219,320.71	199,773.96
Fixed and Deferred Assets	62,884.66	115,215.41	84,196.77
Total Owned Capital	344,666.90	334,536.12	283,970.73

From the foregoing it is seen that the redemptions did not cause either the Owned Net Working Capital or the Total Owned Capital of Capitol Chevrolet Co. to fall below its standards as set by Chevrolet, hence as to this corporation the Tax Court's finding is pure error.

It will also be seen that the redemptions did not cause Mid-Valley Chevrolet Co. to fall below its Total Owned Capital requirements. The redemptions did, however, cause the Owned Net Working Capital of that corporation to fall below the Owned Net Working Capital standard set by Chevrolet.



The redemptions did cause the Total Owned Capital of Howell Chevrolet Co. to fall some \$16,500.00 below the standard set by Chevrolet and also caused the Owned Net Working Capital of that corporation to fall substantially below the Owned Net Working Capital standard set by Chevrolet.

It is respectfully submitted, however, that even in the cases of Mid-Valley Chevrolet Co. and Howell Chevrolet Co. there was no justification for The Tax Court's finding that their falls below the standards set by Chevrolet were grounds for termination of their franchises for the reason that Chevrolet Motor Division had been advised by letter from Mr. Phelps on October 18, 1948, that in eliminating the Trust and the holding company from ownership in the corporation "it may be necessary to reduce our Net Working Capital substantially, and this might result in our being under-capitalized according to the established standard requirements" and had been requested to grant to the corporation a period of six months or a year to work out of their difficulties [R. 155]; and Mr. Connell, the Regional Manager of the Pacific Coast Region of Chevrolet Motor Division had agreed that some extension would be given. [R. 166.]

Under the circumstances it is clear that the deficits in Owned Net Working Capital of Mid-Valley and Howell Chevrolet Co. and the relatively small (5.5%) deficit in the Total Owned Capital of Howell Chevrolet Co. did not violate these corporations' agreements with Chevrolet and that The Tax Court clearly erred in so finding.

It is respectfully submitted, further, that this erroneous finding constitutes prejudicial error for the reason that it forms the only basis for the unstated, but nevertheless implied, conclusion of The Tax Court that the redemptions

in question were not made for the purpose of preserving the corporations' Chevrolet franchises, but for a stockholder purpose which was accomplished at the risk of losing such franchises.

## POINT II.

**The Distributions to Appellants in Redemption of a Part of Their Shares in Each of the Three Corporations Were Not Essentially Equivalent to Distributions of Taxable Dividends for the Reasons: (A) That the Distributions Were Not Made Pro Rata to All Shareholders, (B) That the Sole Purpose of the Distributions Was a Legitimate Corporate Purpose, and (C) the Net Effect of Such Distributions Was Entirely Different From That of Taxable Dividends.**

The statutory provision applicable to this phase of Appellants' argument is Section 115(g) of the Internal Revenue Code of 1939 which provides as follows:

“(g) Redemption of Stock—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.”

In the case of *Earle v. Woodlaw*, Docket No. 15062 of this Court, which was decided on February 28, 1957 and is not yet published, this Court adopted the “judicial criteria” laid down in the case of *Flanagan v. Helvering*,

116 F. 2d 1937, as the factors which are to be considered in reaching a conclusion as to whether or not Section 115(g) is applicable in a given situation. These criteria as set out by the Court in its decision are as follows:

“1. Did the corporation adopt any plan or policy of contraction of its business activities?

“2. Did the corporation follow an orderly procedure looking toward its ultimate dissolution, or its ultimate contracted operation?

“3. Did the initiative for the corporate distribution come from the corporation, based on usual business considerations, or did it come from stockholders, (or a stockholder), for their (or his) own purpose?

“4. Is the proportionate ownership of stock by the shareholders changed?

“5. What were the amounts, the frequency and the significance of dividends paid in the past?

“6. Does the capitalization, at the time of cancellation of the stock, represent capital paid in, or earnings from the business?

“7. Was there a sufficient accumulation of earned surplus to cover the distribution, or was it partly from capital?

“8. Was there a maintenance of a relatively similar amount of capital liability, or did that figure decrease to a degree somewhat comparable to the purported distribution of capital?

“9. Was there good faith, or bad, in the action of the Board of Directors?

“10. What was the net effect of actions taken?

“This last criteria is that of most importance.”

Applying the foregoing tests to the case at bar we find the following:

1. DID THE CORPORATION ADOPT ANY PLAN OR POLICY OF CONTRACTION OF ITS BUSINESS ACTIVITIES?

ANSWER: No. Furthermore, not only did the corporations not adopt any plan for the contraction of their businesses, but also there was no intent to contract and each of the corporations hoped, expected to, and did continue to grow notwithstanding the temporary setback occasioned by the reductions in their capital resulting from the distributions which were made.

2. DID THE CORPORATION FOLLOW AN ORDERLY PROCEDURE LOOKING TOWARD ITS ULTIMATE DISSOLUTION, OR ITS ULTIMATE CONTRACTED OPERATION?

ANSWER: No, because ultimate dissolution or ultimate contracted operations were never contemplated.

3. DID THE INITIATIVE FOR THE CORPORATE DISTRIBUTION COME FROM THE CORPORATION, BASED ON USUAL BUSINESS CONSIDERATIONS, OR DID IT COME FROM STOCKHOLDERS, (OR A STOCKHOLDER), FOR THEIR (OR HIS) OWN PURPOSE?

ANSWER: The initiative for the distributions in the case at bar came solely from the corporations based upon the most important of all business considerations—the preservation of their Chevrolet franchises.

Nowhere in the record is there the slightest suggestion of stockholder initiative and the record is clear that the initiative *did not* come from either of the appellants herein or from Jackson Howell, the other individual shareholder who received a distribution. The evidence supporting this

statement is found in the following testimony of F. Norman Phelps:

“Q. In December, 1948, did you have any need for the money which you received from Capitol Chevrolet Co., Mid-Valley Chevrolet Co., and Howell Chevrolet Co. upon the redemption by those companies of a portion of your stock? A. Did I have any need for it? No particular need, no.

Q. Do you know of your own knowledge whether or not Mrs. Phelps had any need for the money received by her? A. She did not.

Q. In your discussion with Mr. Dempsey concerning the plan to remove the Trust and the holding company from the dealerships, did you ever request that the plan be so drawn that you would receive any cash or property out of the corporations or any of them? A. I did not.

Q. Did you at any time suggest to Mr. Dempsey that it would be a desirable feature of any plan which might be devised by him that you and Mrs. Phelps, or either of you, receive any cash or property from any of the corporations? A. I did not.” [R. 77-78.]

and in the following testimony of Jackson Howell:

“Q. Mr. Howell, what part did you play in this redetermination of stock? Did you play any personal part? A. No, I did not. Let me understand it. What do you mean?

Q. In the formulating of the plans or the manner in which it was accomplished. A. No, I did not. As I mentioned, the first I knew about it was after the die was cast. I was told to issue the checks.

Q. After the plan had been adopted? A. Subsequently.

Q. You did not vote yes or no yourself or have an opportunity to vote? A. No, I did not.” [R. 210.]



In connection with a consideration of this test it should be noted that The Tax Court, instead of basing its decision on the “business considerations” affecting the three corporations which made the distributions, based the decision on the fact that there was no policy of Chevrolet Motor Division which required the redemptions, stating:

“. . . It is no answer to say that these transactions had their origin in the demand of Chevrolet that the trust be eliminated as a stockholder. That objective could have been achieved, and indeed with less strain upon the corporations, merely by redeeming the shares of the trust. However, Kenyon did not wish to have his control diluted, and Connell, the regional manager for Chevrolet, had himself suggested to Phelps that it would be fair to preserve the same ratios of control. But that suggestion did not represent Chevrolet policy, and we do not believe, on the evidence, that Phelps regarded it as such. It was an objective that the parties themselves would undoubtedly have desired to attain, wholly apart from any suggestion emanating from Connell. Certainly, petitioners, who have the burden of proof, have not shown otherwise . . .” [R. 42, 43.]

Counsel for Appellants submit that the Court’s finding that “we do not believe, on the evidence, that Phelps regarded” Connell’s suggestion as representing Chevrolet policy is wholly unsupported by the record since there is no evidence in the record, other than the incompetent testimony of Mr. Connell upon which the Court states that it did not rely, from which such a finding could be made.

However, conceding for the purpose of argument only that Mr. Phelps did not regard Mr. Connell’s “suggestion”

relative to the maintenance of Mr. Kenyon's controls in the three corporations as representing Chevrolet policy, that does not make the suggestion itself any the less a valid "business consideration" for what was done.

The record is conclusive that the "suggestion" of Mr. Connell was made by him in his capacity as Regional Manager of the Pacific Coast Region of Chevrolet Motor Division. [R. 155-157.] Coming from him in that capacity the suggestion was that of Chevrolet Motor Division, and the record is likewise conclusive that Mr. Phelps, who had personal knowledge of other Chevrolet dealerships being cancelled for failure to comply with suggestions of Chevrolet Motor Division [R. 82], believed that unless such suggestion were complied with the three corporations' franchises either would not be renewed the following year or would be cancelled. [R. 77.] Mr. Phelps, who had been an employee of Chevrolet Motor Division for twenty-five years prior to the formation of the three corporations, had a very fundamental viewpoint concerning "suggestions" coming from that Division which is clearly shown by the following testimony:

"Q. Can you, based upon extensive experience, give me any synonyms that you think mean the same thing from your experience with the word 'suggestion' or 'request' as it relates to a request or a suggestion from the Chevrolet Motor Division to a dealer? A. I don't know about a synonym, but it is hard to explain. If Chevrolet Motor Division suggests that you do something, the dealer assumes that they want it done, and they do it. They just do not want to take any chances. That's the

whole thing. I don't think it is a command or anything of the kind, but the dealer takes it as such." [R. 84, 85.]

In determining whether or not a valid "business consideration" existed for maintaining Mr. Kenyon's relative controls in the three corporations by means of the redemptions which were made, does it make any difference whether Mr. Phelps', and through him the dealerships', fears of losing their franchises were based on knowledge that the control requirement emanated from Chevrolet policy, or merely wishes, or even a mere whim of the Regional Manager, *so long as those fears were real?* Obviously it does not; and equally obviously the finding of The Tax Court above quoted is not germane to the question to be decided.

The proper question of fact upon which The Tax Court should have made its finding was whether or not Mr. Phelps believed that the three corporations' Chevrolet franchises were in danger of being lost if the corporations had failed to comply with Mr. Connell's suggestion that Mr. Kenyon's control in the three corporations be not changed, and the only finding which the Court could have made on that question would have come from the following testimony of Mr. Phelps:

"Q. (By Mr. Thayer): Based upon your experience as an employee of the Chevrolet Motor Division, particularly your experience as Regional Manager of the Pacific Coast Region, did you have a belief in 1948 as to the consequences to the three dealerships, (Capitol Chevrolet Co., Mid-Valley Chevrolet Co., and Howell Chevrolet Co. of their

failure to comply with the suggestion of Mr. J. L. Connell that the Trust and holding company be removed from ownership of stock in such dealerships in such a manner as not to disturb the then existing proportionate control of yourself and Mr. Kenyon in those corporations?

Mr. Townsend: Would you just answer that yes or no, Mr. Phelps?

The Witness: Yes, I did.

\* \* \* \* \*

The Witness: My belief was that over a period of years that when Chevrolet makes a suggestion that you comply with that suggestion, and I assumed that Mr. Connell wanted to leave everything exactly the same as it was, because we were going along pretty well on an equal basis, Mr. Kenyon and myself particularly; and as far as any dealer doing other than what Chevrolet wants them to do, they just don't do it.

Q. (By Mr. Thayer): What was your belief as to the effect upon the dealerships of their failure to comply with these suggestions? A. It was my firm belief that unless we complied with Chevrolet's demands and requests that either our franchise would not be renewed next year or our franchise would have been cancelled, because we were going against a direct policy of theirs. That is the only reason we did it.

Q. Did you have that belief in 1948? A. Yes."  
[R. 75-77.]

4. IS THE PROPORTIONATE OWNERSHIP OF STOCK BY THE SHAREHOLDERS CHANGED?

ANSWER: Yes. Such change is clearly shown by the following table of stock ownership percentages before and after the distributions:

<u>Stockholder</u>	<u>Percentage Ownership Before Distribution</u>	<u>Percentage Ownership After Distribution</u>
<i>Capitol Chevrolet Co.</i>		
F. Norman Phelps	24.94	24.92
Alice Phelps	25.06	25.08
Patricia May Kenyon Trust	20.00	6.78
J. A. K. Co.	30.00	43.22
<i>Mid-Valley Chevrolet Co.</i>		
F. Norman Phelps	25.06	25.08
Alice Phelps	24.94	24.92
Patricia May Kenyon Trust	20.00	6.78
J. A. K. Co.	30.00	43.22
<i>Howell Chevrolet Co.</i>		
F. Norman Phelps	16.67	16.67
Alice Phelps	16.67	16.67
Patricia May Kenyon Trust	13.33	3.33
J. A. K. Co.	20.00	30.00
Jackson Howell	33.33	33.33

5. WHAT WERE THE AMOUNTS, THE FREQUENCY AND THE SIGNIFICANCE OF DIVIDENDS PAID IN THE PAST?

ANSWER: No dividends had ever been paid by any of the corporations, but there were very sound business reasons why no such dividends had been paid.

Each of the corporations had been formed on April 10, 1946, and each of them was required by the terms of its Capital Standards Agreement with Chevrolet Motor Di-



vision to build up, prior to August 15, 1948, and to maintain thereafter, a Total Owned Capital of not less than \$300,533.00, with failure to do so constituting grounds for termination of its franchise. By December 31, 1946, none of the corporations had attained this required status, and each of them had its capital fully employed in its business operations.

By December 31, 1947, Capitol Chevrolet Co. had built up its Total Owned Capital to \$325,856.62 and could, therefore, have paid a dividend of some \$25,000.00 without violating its Capital Standards Agreement. However, on December 31, 1947, this corporation had cash on hand of only \$75,443.74 and current liabilities, including federal income taxes for the year, of \$273,479.75.

On December 31, 1947, Mid-Valley Chevrolet Co. had built up its Total Owned Capital to \$310,853.04 and could have paid a dividend of some \$10,000.00 without violation of its Capital Standards Agreement. However, this corporation's cash on hand on December 31, 1947, was only \$186,026.15, whereas its current liabilities, including federal income taxes for the year, amounted to \$234,129.35.

Comparing the cash balances of these two corporations with their cash requirements it seems clear that their failure to pay dividends in the year 1947 was dictated by prudent business judgment.

On December 31, 1947, Howell Chevrolet Co. had built up its Total Owned Capital to only \$287,643.74 and was still short of its contract requirement, hence its decision not to pay a dividend for that year can hardly be questioned.

The payment of dividends in the year 1948 was, of course, made impossible by the very distributions which

are here in question for the reason that such distributions reduced the corporations' working capital below the minimum required for their continued operations.

6. DOES THE CAPITALIZATION, AT THE TIME OF CANCELLATION OF THE STOCK, REPRESENT CAPITAL PAID IN, OR EARNINGS FROM THE BUSINESS?

ANSWER: Capital paid in.

7. WAS THERE A SUFFICIENT ACCUMULATION OF EARNED SURPLUS TO COVER THE DISTRIBUTION, OR WAS IT PARTLY FROM CAPITAL?

ANSWER: There was a sufficient accumulation of earned surplus in each corporation to cover the distribution in full, but each distribution was made partly from capital and partly from surplus.

8. WAS THERE A MAINTENANCE OF A RELATIVELY SIMILAR AMOUNT OF CAPITAL LIABILITY, OR DID THAT FIGURE DECREASE SOMEWHAT COMPARABLE TO THE PURPORTED DISTRIBUTION OF CAPITAL?

ANSWER: In the case of each corporation, capital liability decreased in substantially the same ratio as the capital distribution, to-wit:

	<u>Percentage of capital distributed</u>	<u>Percentage decrease in capital liability</u>
(a) Capitol Chevrolet Co.	30.5%	32.5%
(b) Mid-Valley Chevrolet Co.	30.5%	32.5%
(c) Howell Chevrolet Co.	32.9%	33.3%

9. WAS THERE GOOD FAITH, OR BAD, IN THE ACTION OF THE BOARD OF DIRECTORS?

ANSWER: In each case the Board of Directors acted in the utmost good faith and in reliance upon the recom-

mentation of competent counsel made after a long study in which the possible alternatives to the distributions in question were given full consideration and only rejected because impossible of accomplishment.

10. WHAT WAS THE NET EFFECT OF ACTIONS TAKEN?

ANSWER: To answer this question requires a definition of the term and that definition is found in the opinion of this Court in *Earle v. Woodlaw, supra*, where, immediately following the question, the Court states:

“If all purchases of its own stock by a corporation taken together accomplish the same result as the declaration of a dividend, a gain derived by a stockholder therefrom is taxable as a dividend.”

Under this definition, the answer to the question in the case at bar is clear and is simply this:

“The net effect of the actions taken was not equivalent to that of a taxable dividend because payment of an ordinary dividend in the same amount, or in any amount, would not have accomplished the same result.”

To establish the accuracy of this answer we must start with the result which was accomplished by the distributions which were actually made. This result had two distinct features, namely:

(a) The reduction of the number of shares owned by the Patricia May Kenyon Trust from 170 to 40 in Capitol Chevrolet Co., from 170 to 40 in Mid-Valley Chevrolet Co. and from 120 to 20 in Howell Chevrolet Co., and

(b) The maintenance of James A. Kenyon's percentage of control in both Capitol Chevrolet Co., and

Mid-Valley Chevrolet Co. at 50% and the maintenance of his percentage of control in Howell Chevrolet Co. at  $33\frac{1}{3}\%$  notwithstanding his loss of voting power resulting from the reduction of the Trust's ownership in the three corporations.

Obviously, no ordinary dividend could have accomplished both of the foregoing features because no ordinary dividend would have reduced the Trust's ownership in any of the corporations; and counsel for Appellants believe that this fact, standing alone, should be sufficient to meet the "net effect" test. However, since it may be argued that an ordinary dividend, coupled with some appropriate action on the part of the shareholders, could have achieved both of the required features, counsel believe it to be appropriate to show that *no dividend* coupled with any possible action on the part of any shareholder could have accomplished the same result as was accomplished by the distributions which were actually made.

One of the required features of the result accomplished by the distribution actually made was the reduction of the Trust's ownership of stock in the three corporations, and that feature could have been accomplished in only two ways:

(1) Redemption by the corporations of the Trust owned shares, or

(2) Sale by the Trust of its shares of stock in the corporations.

The other required feature of the result was that Mr. Kenyon's relative control in the three companies remain unchanged after the reduction of the Trust's stock ownership in the corporations, and, absent a retirement by the

corporations of a part of the stock owned by the other individual shareholders, that feature could have been accomplished only by having either J. A. K. Co., or Mr. Kenyon:

(a) Purchase from each of the corporations one share of stock for each Trust share redeemed; or

(b) Purchase from Mr. or Mrs. Phelps one-half share of Capitol Chevrolet Co. and Mid-Valley Chevrolet Co. stock for each share of Trust stock redeemed by those corporations and purchase from Mr. or Mrs. Phelps and from Jackson Howell one-third share of Howell Chevrolet Co. stock for each Trust share redeemed by that corporation; or

(c) Purchase the Trust owned shares directly from the Trust.

Combining the two methods by which the Trust's ownership in the corporations could be reduced with the three methods by which Mr. Kenyon's control in the corporations could have been maintained at its existing level we find that there were the following three alternatives, employing the use of ordinary dividends instead of the redemption of Appellants' and Jackson Howell's shares, which *seemingly* might have accomplished the necessary result, namely:

*Alternative 1.* Redemption of the Trust shares by the companies to the same extent as was actually done, followed by the purchase by J. A. K. Co. or James A. Kenyon of 130 shares directly from each Capitol Chevrolet Co. and Mid-Valley Chevrolet Co., and 100 shares from Howell Chevrolet Co., such purchase being followed in turn by the payment by the three corporations of ordinary



dividends in an amount sufficient to yield the purchaser the funds necessary to pay the purchase price.

*Alternative 2.* Redemption of the Trust shares by the companies to the same extent as was actually done, followed by the purchase by either J. A. K. Co. or James A. Kenyon personally of 65 shares of Capitol Chevrolet stock and 65 shares of Mid-Valley Chevrolet stock from Mr. or Mrs. Phelps, and the purchase of  $33\frac{1}{3}$  shares of Howell Chevrolet stock from Mr. or Mrs. Phelps, and a like number of such corporation's shares from Mr. Howell, such purchases being followed in turn by the payment of ordinary dividends by the three corporations in an amount sufficient to yield the purchaser the funds necessary to pay the purchase price.

*Alternative 3.* Sale of the Trust shares either to J. A. K. Co. or to James A. Kenyon, followed by the payment of ordinary dividends *by the three corporations* in an amount sufficient to enable the purchaser to pay the purchase price of such shares.

The question which must be answered, then, is this:

“If any one of the foregoing alternatives had been adopted would it in fact have accomplished the same result as that which was accomplished by what was done?”

With the answer to this question as our goal let us examine each of these alternatives in turn:

*Alternative 1:*

Since this alternative, on its face, would require the payment of ordinary dividends in twice the amount required by Alternative 2, we shall not pursue it further because, as it will be seen, Alternative 2 itself would not have accomplished the required result.

*Alternative 2:*

Under this alternative the three corporations would have redeemed the Trust shares in the same manner as was actually done and following such redemption either J. A. K. Co. or Mr. Kenyon would have purchased from Mr. or Mrs. Phelps the number of shares (65 in each corporation) required to maintain his 50% control in Capitol Chevrolet Co. and Mid-Valley Chevrolet Co. and either J. A. K. Co. or Mr. Kenyon would have purchased  $33\frac{1}{3}$  shares of Howell Chevrolet Co. stock from Mr. or Mrs. Phelps and a like number from Jackson Howell in order to maintain his  $33\frac{1}{3}\%$  control in that company.

Also, under this alternative, and for the purpose of applying the "net effect" test, the three corporations will be assumed to have paid, after the redemption of the Trust shares and after the purchases by J. A. K. Co. or Mr. Kenyon, ordinary dividends in amounts equal to the difference between the total amounts which were actually distributed and the amounts required to redeem only the Trust shares. Under this alternative, then, the critical point to be determined is whether or not the payment of such dividends would have enabled either J. A. K. Co. or Mr. Kenyon to have paid the purchase price of the shares purchased from Mr. or Mrs. Phelps and from Mr. Howell.

The detailed computations by which this determination is made are set out in full in the Appendix, pages 1 to 5 and the determination is this: If J. A. K. Co. had been the purchaser, the net amount available to it to apply in the purchase of the shares would have fallen short of the purchase price by \$91,920.25, and if James A. Kenyon had been the purchaser the net amount avail-

able to him to apply in the purchase of the shares would have fallen short of the purchase price by \$55,168.96.

It is clear, therefore, that this alternative would not have accomplished the same result as that which was accomplished by what was done since it would not have enabled Mr. Kenyon to maintain his control in the three corporations.

Furthermore, not only would ordinary dividends in an amount equal to the distributions which were actually made not have accomplished the same result, but also it is a fact, which is proven in the computations appearing on pages 6 to 10 of the Appendix, that if this alternative had been adopted and if each of the three corporations *had paid out their entire earned surpluses* as ordinary dividends the net amount available to either J. A. K. Co., if it had been the purchaser of the Phelps and Howell shares, or to James A. Kenyon, if he had been the purchaser of such shares, would not have been sufficient to pay the purchase price of such shares!

### *Alternative 3:*

Under this alternative the corporations would not have redeemed any shares and either J. A. K. Co. or Mr. Kenyon would simply have purchased directly from the Trust 130 Capitol Chevrolet Co. shares, 130 Mid-Valley Chevrolet Co. shares and 100 Howell Chevrolet Co. shares. Following this purchase, and for the purpose of applying the "net effect" test, the three corporations will be assumed to have paid, after such purchase, ordinary dividends in

an amount equal to the full distributions which were actually made.

Under this alternative the critical point to be determined is similar to the point for determination under Alternative 2, *i.e.*, “Would the payment of such dividends have enabled either J. A. K. Co. or Mr. Kenyon to have paid the purchase price of the shares purchased from the Trust?”

The detailed computations by which such determination is made are set out in full in the Appendix, pages 11 to 15 and the determination is this: If J. A. K. Co. had been the purchaser of the shares the net amount available to it to apply in the purchase of the shares would have fallen short of the purchase price by \$170,304.02; and if Mr. Kenyon, personally, had been the purchaser the net amount available to him to apply in the purchase of the shares would have fallen short of the purchase price by \$135,804.58.

It is clear, therefore, that this alternative would also have failed to accomplish the same result as that which was accomplished by what was done since it, too, would not have enabled Mr. Kenyon to maintain his control in the three corporations.

As in the case of Alternative 2, it can be demonstrated that (under this alternative) not only would ordinary dividends in an amount equal to the distributions which were actually made not have accomplished the same result as that which was actually accomplished, but also that even if the three corporations had paid out their *entire* earned

surpluses as ordinary dividends the net amount available to either J. A. K. Co., if it had been the purchaser of the Trust shares, or to Mr. Kenyon if he had been the purchaser of such shares, would have fallen far short of the amount required for the payment of the purchase price of such shares. The detailed computations demonstrating this fact are set forth in the Appendix, pages 15 to 20.

### Conclusion—Point II.

From the foregoing it has been seen that the distributions here in question pass all of the tests required for exclusion from the operation of Section 115(g) other than numbers 1, 2, 5 and 7. Therefore, even if these tests were to be given equal weight the scales are tipped in favor of Appellants. Moreover, since this Court has held in the *Earle* case, *supra*, that the tests are not to be given equal weight, and that it is the “net effect” test which is of the most importance, and since there are included among the tests which have been passed both that of legitimate business purpose (which was held to be of great importance in *Commissioner v. Sullivan*, 210 F. 2d 607) and that of non-pro rata distribution (which is uniformly held by the Courts to be a strong factor in the determination) it is respectfully submitted that the scales are tipped, not slightly, but predominately, in Appellants’ favor and that The Tax Court clearly erred in failing to hold that the distributions to Appellants were not essentially equivalent to taxable dividends.



### POINT III.

The Distributions to Appellants in Redemption of a Part of Their Shares in Each of the Three Corporations Constituted Amounts Distributed in Partial Liquidation of the Corporations and Were Properly Reported as Such by Appellants on Their Return for the Year 1948.

Sections 115(c) and 115(i) of the Internal Revenue Code of 1939 provide as follows:

“(c) (as amended by Sec. 147 of the Revenue Act of 1942 *supra*) Distributions in Liquidation.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed (whether before January 1, 1939, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits.

\* \* \*

“(i) Definition of Partial Liquidation.—As used in this section the term ‘amounts distributed in partial liquidation’ means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.”

The redemptions of Appellants' 65 shares, each, of stock in Capitol Chevrolet Co. and Mid-Valley Chevrolet Co. and the redemption of their 50 shares, each, of stock in Howell Chevrolet Co. constituted partial liquidations of those corporations and the amounts distributed to Appellants constituted amounts distributed in partial liquidation within the meaning of Section 115(i) of the Internal Revenue Code of 1939. Under Section 115(c) of the Code such amounts were required to be treated as payment in exchange for the shares redeemed, hence Appellants' action in so treating them on their return for the year 1948 was proper and The Tax Court erred in failing so to find.

### Conclusion.

The decision of The Tax Court of the United States is clearly erroneous and should be reversed.

Respectfully submitted,

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## APPENDIX.

### Computation of Amount Available to J.A.K. Co. as Purchaser or James A. Kenyon as Purchaser for Payment of Purchase Price of Phelps and Howell Shares Under Alternative 2.

(A) Amounts to be distributed as ordinary dividends:

	<u>Capitol</u>	<u>Mid-Valley</u>	<u>Howell</u>
Total Distribution	\$151,036.60	148,681.00	139,524.00
Distributed to Trust	<u>75,518.30</u>	<u>74,340.50</u>	<u>46,508.00</u>
Available for Distribution as Ordinary Dividend	\$ 75,518.30	74,340.50	93,016.00

(B) Purchase price of shares to be purchased:

65 Shares Capitol	\$ 37,759.15
65 Shares Mid-Valley	37,170.25
66 $\frac{2}{3}$ Shares Howell	<u>31,005.33</u>
Total	\$105,934.73

### CASE I—ASSUME J.A.K. CO. AS PURCHASER

If J.A.K. Co. were to have been the purchaser of the shares from Mr. or Mrs. Phelps and Jackson Howell, then upon distribution of the ordinary dividend after redemption of the trust shares it would have received the following dividends from the three companies:

*Capitol:*

$$\frac{320}{720} \times 75,518.30 = 33,563.69$$

*Mid-Valley:*

$$\frac{320}{720} \times 74,340.50 = 33,040.22$$

*Howell:*

$$\frac{246\frac{2}{3}}{800} \times 93,016 = 28,679.93$$

Total Dividends Received	\$95,283.84
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Assuming J.A.K. Co. to have had no other income its tax on these dividends would have been:

*Federal Normal and Surtax*

Net Income	\$95,283.84
Less: Dividends received credit	80,991.26 (a)
	<hr/>
Total subject to normal and surtax	<u>\$14,292.58</u>
Tax: On first \$5,000	\$1,050.00
On next \$9,293.43	2,137.29
	<hr/>
Total normal and surtax	\$3,187.29 (b)

*Federal Personal Holding Company Surtax*

Net Income	\$95,283.84
Less: Normal and surtax	3,187.29
	<hr/>

Undistributed Net Income subject to	
Personal Holding Company Surtax	<u>\$92,096.55 (c)</u>
Tax: On first \$2,000	\$ 1,500.00
On \$90,096.55	76,582.07
	<hr/>
Total Personal Holding Company Surtax	\$78,082.07 (d)

*Recap:*

Normal and Surtax	\$ 3,187.29
Personal Holding Company Surtax	78,082.07
	<hr/>
Total Tax	\$81,269.36

The maximum amount available to J.A.K. Co. to apply to the purchase price of the Phelps and Howell shares would have been the excess of the dividends received by it from the three companies over the total taxes payable on such dividends:

Total dividends	\$ 95,283.84
Total taxes payable	81,269.36
	<hr/>
Available to apply to purchase	\$ 14,014.48

CONCLUSION:

Purchase Price	\$105,934.73
Available to J.A.K. Co.	14,014.48
	<hr/>
Shortage	\$ 91,920.25

## CASE II—ASSUME JAMES A. KENYON AS PURCHASER

If Mr. Kenyon were to have been the purchaser of the shares from Mr. or Mrs. Phelps and Jackson Howell, then upon distribution of the ordinary dividend after redemption of Trust shares he and J.A.K. Co. would have received the following dividends from the three companies:

*Capitol:* *J.A.K. Co. James A. Kenyon*

$$\text{J.A.K. Co.: } \frac{255}{720} \times 75,518.30 = 26,746.06$$

$$\text{Kenyon: } \frac{65}{720} \times 75,518.30 = 6,817.62$$

*Mid-Valley:*

$$\text{J.A.K. Co.: } \frac{255}{720} \times 74,340.50 = 26,328.93$$

$$\text{Kenyon: } \frac{65}{720} \times 74,340.50 = 6,711.30$$

*Howell:*

$$\text{J.A.K. Co.: } \frac{180}{800} \times 93,016.00 = 20,928.60$$

$$\text{Kenyon: } \frac{66\frac{2}{3}}{800} \times 93,016.00 = 7,751.33$$

TOTAL J.A.K. Co. \$74,003.59

TOTAL JAMES A. KENYON \$21,280.25

Assuming J.A.K. Co. to have had no other income, its tax on these dividends would have been:

*Federal Normal and Surtax:*

Net Income	\$74,003.59
Less: Dividends received credit	62,903.05 (a)

Total subject to normal and surtax	<u>\$11,100.54</u>
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Tax: On first \$5,000	\$1,050.00
On next \$6,100.54	1,403.12

Total normal and surtax	<u>\$2,453.12 (b)</u>
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J.A.K. Co. would, therefore, have been able to pay to Mr. Kenyon a dividend in an amount equal to the difference between the total dividends received by it from the three corporations and the taxes payable upon such dividends:

Total dividends received	\$74,003.59
Taxes payable thereon	2,453.12
Available for distribution to Mr. Kenyon	<u>\$71,550.47</u>

The dividends received by Mr. Kenyon from the three corporations and from J.A.K. Co. would have been taxable income to him and would have been in addition to his other income for the year, making him subject to Federal and California income taxes as follows:

*Federal Tax*

Net income from all sources other than dividends from the three corporations and J.A.K. Co. [R. 193]	\$106,429.40
Dividends from the three corporations	21,280.25
Dividends from J.A.K. Co.	71,550.47
Total taxable net income	<u>\$199,260.12</u>
Personal exemption and credit for dependents	1,200.00 (e)
Subject to tax	<u><u>\$198,060.12</u></u>
Tentative Normal and Surtax:	
On \$150,000	\$111,820.00
On \$48,060.12 at 90%	43,254.11
Total tentative tax	<u>\$155,074.11 (f)</u>
1948 Reduction:	
On \$100,000	12,020.00
On \$55,074.11 at 9.75%	5,369.73
	<u>17,389.73 (g)</u>
Total Normal and Surtax after Reduction	\$137,684.38
Limited to 77% of \$199,260.12	153,430.29 (h)
Total Federal tax payable	<u>\$137,684.38</u>
*        *        *        *        *	*        *

*California Tax:*

Total net income per Federal	\$199,260.12
Add: 1947 California income taxes not deductible	972.77 (i)
California net taxable income	<u>\$200,232.89</u>
Personal exemption and credit for dependents	3,400.00 (j)
Subject to tax	<u><u>\$196,832.89</u></u>

Tax:

On first \$30,000	800.00
On \$166,832.89 at 6%	10,009.97 (k)

Total California Tax	<u>\$10,809.97</u>
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RECAP:

Federal tax payable	\$137,684.38
California tax payable	10,809.97
Total	<u>\$148,494.35</u>

The maximum amount available to Mr. Kenyon to apply to the purchase price of the Phelps and Howell shares would be the excess of his total net income for the year, including the dividends from the three corporations and J.A.K. Co., over his total taxes payable for the year:

Total net income	\$199,260.12
Total taxes payable	148,494.35
Available to apply to purchase	<u>\$ 50,765.77</u>

CONCLUSION

Total purchase price of Phelps and Howell shares	\$105,934.73
Amount available to apply to purchase price	50,765.77
Shortage	<u>\$ 55,168.96</u>

Proof of the Fact That It Would Have Been Impossible for the Three Corporations to Have Paid Ordinary Dividends in an Amount Sufficient to Enable James A. Kenyon to Pay the Purchase Price of 65 Shares of Capitol Chevrolet Co. Stock, 65 Shares of Mid-Valley Chevrolet Co. Stock and 66-2/3 Shares of the Howell Chevrolet Stock if He Had Purchased Such Shares From Mr. or Mrs. Phelps and Jackson Howell After the Trust Shares Had Been Redeemed.

*Factors:*

(1) The purchase price to be paid for the purchased shares would have been the same as the redemption price, *i.e.*

65 sh. Capitol Chevrolet Co.	\$ 37,759.15
65 sh. Mid-Valley Chevrolet Co.	37,170.25
66-2/3 sh. Howell Chevrolet Co.	31,005.33
	<hr/>
	\$105,934.73

(2) The corporate earned surpluses which would have been available for payment of ordinary dividends after the redemption of the Trust shares would have been:

*Capitol Chevrolet Co.*

Actual surplus at 12-31-48		
[Jt. Ex. 21-V; Appx. p. 57]		\$285,666.90
Amount distributed in redemption of Phelps shares	\$75,518.30	
Portion of Phelps redemption charged to capital	13,000.00	
	<hr/>	
Portion of Phelps redemption charged to surplus	\$62,518.30	62,518.30
		<hr/>
Earned surplus which would have been on hand if Phelps redemption had not been made		\$348,185.20



*Mid-Valley Chevrolet Co.*

Actual surplus at 12-31-48 [Jt. Ex. 16-P; Appx. 54]		\$275,536.12
Amount distributed in redemption of Phelps shares	\$74,340.50	
Portion of Phelps redemption charged to capital	<u>13,000.00</u>	
Portion of Phelps redemption charged to surplus	61,340.50	<u>61,340.50</u>
Earned surplus which would have been on hand if Phelps redemption had not been made		\$336,876.62

*Howell Chevrolet Co.*

Actual surplus at 12-31-48 [Jt. Ex. 11-K; Appx. 51]		\$223,970.73
Amount distributed in redemption of Phelps and Howell shares	\$93,016.00	
Portion of Phelps and Howell redemptions charged to capital	<u>20,000.00</u>	
Portion of Phelps and Howell redemption charged to surplus	73,016.00	<u>73,016.00</u>
Earned surplus which would have been on hand if Phelps and Howell re- demptions had not been made		\$296,986.73

(3) If James A. Kenyon had purchased 65 shares of Capitol Chevrolet Co. and 65 shares of Mid-Valley Chevrolet Co. from Mr. or Mrs. Phelps and had purchased  $33\frac{1}{3}$  shares of Howell Chevrolet Co. from Mr. or Mrs. Phelps and a like number of Howell shares from Jackson Howell after the Trust shares had been redeemed, and if following such purchases the corporations had paid out, as ordinary dividends, their *entire* earned surpluses which would then have been on hand, J.A.K. Co. and James A. Kenyon would have received the following dividends:

Capitol Chevrolet Co.:

J.A.K. Co. James A. Kenyon

$$\text{J.A.K. Co.: } \frac{255}{720} \times 348,185.20 = 123,315.59$$

$$\text{Kenyon: } \frac{65}{720} \times 348,185.20 = 31,433.39$$

Mid-Valley Chevrolet Co.

$$\text{J.A.K. Co.: } \frac{255}{720} \times 336,876.62 = 119,310.47$$

$$\text{Kenyon: } \frac{65}{720} \times 336,876.62 = 30,412.47$$

Howell Chevrolet Co.

$$\text{J.A.K. Co.: } \frac{180}{800} \times 296,986.73 = 66,822.01$$

$$\text{Kenyon: } \frac{66\frac{2}{3}}{800} \times 296,986.73 = 24,748.89$$

TOTAL J.A.K. Co. \$309,448.07

TOTAL James A. Kenyon \$86,594.75

(4) If J.A.K. Co. had no income other than the dividends which it would have received from the three corporations it would have been able to pay a dividend to James A. Kenyon equal to the entire amount of such dividends so received by it less the amount of Federal income tax due on the amount so received:

Net Income	\$309,448.07
Less: Dividends received credit	<u>263,030.86 (a)</u>

Total taxable	\$ 46,417.21
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Tax: On first \$5000 —	\$ 1050.00
“ next 15,000 —	3,450.00
“ next 5,000 —	1,250.00
“ next 21,417.21 —	<u>11,351.12</u>

Total Tax	\$17,101.12 (b)
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Total dividends received —	\$309,448.07
Federal tax thereon —	<u>17,101.12</u>

Available for distribution to James A. Kenyon	<u>\$292,346.95</u>
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(5) The dividends received by James A. Kenyon from the three corporations and from J.A.K. Co. would have been taxable income to him and would have been in addition to the other income for the year, making him subject to Federal and California income taxes as follows:

*Federal tax:*

Net income from all such other than dividends from the three corporations and J.A.K. Co. (R. 193)	\$106,429.40
Dividends from the three corporations	86,594.75
Dividends from J.A.K. Co.	292,346.95
	<hr/>
Total taxable net income	\$485,371.10
Personal exemption and credit for dependents	1,200.00 (e)
	<hr/>
Subject to tax	\$484,171.10

*Tentative Normal Tax and Surtax:*

On \$200,000	\$156,820.00
On 284,171.10 @ 91%	258,595.70
	<hr/>
Total Tentative Tax	\$415,415.70 (f)

*1948 Reduction:*

On \$100,000	\$ 12,020.00	
On \$315,415.70 @ 9.75%	30,753.03	42,773.03 (g)
	<hr/>	<hr/>
Total normal and surtax after reduction		\$372,642.67
Limited to 77% of \$485,371.10		\$373,735.75 (h)
Total Federal tax payable		\$372,642.67

*California Tax:*

Total net income per Federal	\$485,371.10
Add: 1947 California income taxes not deductible	972.77 (i)
	<hr/>
California net taxable income	486,343.87
Personal exemption and credit for dependents	3,400.00 (j)
	<hr/>
Subject to tax	482,943.87
	<hr/>
Tax on first \$30,000 =	800.00
Tax on \$452,943.87 @ 6% =	27,176.63
Total California tax	\$27,976.63 (k)

RECAP:

Federal tax payable	\$372,642.67
California tax payable	27,976.63
Total taxes payable for year	<u>\$400,619.30</u>

(6) The maximum amount available to James A. Kenyon for use in paying the purchase price of the shares purchased from Mr. and/or Mrs. Phelps and Jackson Howell would be his net taxable income received from all sources during the year less the Federal and California income taxes payable for such year:

Total net income from all sources	\$485,371.10
Total Federal and California income taxes payable	<u>400,619.30</u>
Total amount available for payment of purchase price of shares purchased from Mr. and/or Mrs. Phelps and Jackson Howell	\$ 84,751.80

### CONCLUSION

Since the purchase price of the shares purchased from Mr. and Mrs. Phelps and Jackson Howell would have been \$105,934.73 and since the total amount, including his entire income from all sources, which James A. Kenyon would have been able to apply to such purchase if the three corporations had paid out every penny of their earned surpluses as ordinary dividends would have been only \$84,751.80, it follows that it would have been *impossible* for the three corporations to have paid ordinary dividends in an amount sufficient to enable Mr. Kenyon to pay the purchase price of such shares.

(Notes (a) through (k): See Appx. p. 21 for statutory authority for factors used.)

Computation of Amount Available to J.A.K. Co. as Purchaser, or James A. Kenyon as Purchaser, for Payment of Purchase Price of Trust Shares Under Alternative 3.

(A) Amounts to be distributed as ordinary dividends:

<i>Capitol</i>	<i>Mid-Valley</i>	<i>Howell</i>
\$151,036.60	\$148,681.00	\$139,524.00

(B) Purchase price of shares to be purchased:

130 sh. Capitol	75,518.30
130 sh. Mid-Valley	74,340.50
100 sh. Howell	46,508.00

Total	196,366.80
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CASE I: ASSUME J.A.K. CO. AS PURCHASER.

If J.A.K. Co. were to have been the purchaser of the shares from the Trust, then upon distribution of the ordinary dividend it would have received the following amounts from the three companies:

*Capitol:*

$$\frac{385}{850} \times \$151,036.61 = \$68,410.70$$

*Mid-Valley:*

$$\frac{385}{850} \times 148,681.00 = 67,343.75$$

*Howell:*

$$\frac{280}{900} \times 139,524.00 = 43,407.47$$

Total	\$179,161.92
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Assuming J.A.K. Co. to have had no other income, its tax on these dividends would have been:

*Federal Normal and Surtax:*

Net income	\$179,161.92
Less: Dividends received credit	152,287.63 (a)
	<hr/>
Total subject to normal and surtax	\$ 26,874.29
Tax: On first \$5,000 —	\$1,050.00
" next 15,000 —	3,450.00
" next 5,000 —	1,250.00
" next 1,874.29	993.37
	<hr/>
Total normal and surtax	\$6,743.37 (b)

*Federal Personal Holding Company Surtax:*

Net income	\$179,161.92
Less: Normal and surtax	6,743.37
	<hr/>
Undistributed net income subject to personal holding company surtax	\$172,418.55 (c)
Tax on first \$2,000	\$ 1,500.00
Tax on 170,418.55	144,855.77
	<hr/>
Total personal holding company surtax	\$146,355.77 (d)

RECAP:

Normal and surtax	\$ 6,743.37
Personal holding company surtax	146,355.77
	<hr/>
	\$153,099.14

The maximum amount available to J.A.K. Co. to apply to the purchase price of the trust shares would be the excess of the total dividends received by it from the three companies over the total taxes payable on such dividends:

Total dividends	\$179,161.92
Total taxes payable	153,099.14
	<hr/>
Available to apply to purchase	\$26,062.78

CONCLUSION:

Total purchase price of trust shares	\$196,366.80
Amount available to apply to purchase price	26,062.78
	<hr/>
Shortage	\$170,304.02

## CASE II: ASSUME JAMES A. KENYON AS PURCHASER

If Mr. Kenyon had been the purchaser of the shares from the Trust, then upon distribution of the ordinary dividend he and J.A.K. Co. would have received the following dividends from the three companies:

<u>Capitol:</u>		<u>J.A.K. Co.</u>	<u>James A. Kenyon</u>
J.A.K. Co.	$\frac{255}{850} \times 151,036.61 =$	45,310.98	
Kenyon	$\frac{130}{850} \times 151,036.61 =$		23,099.72
<i>Mid-Valley:</i>			
J.A.K. Co.	$\frac{255}{850} \times 148,681.00 =$	44,604.30	
Kenyon	$\frac{130}{850} \times 148,681.00 =$		22,739.45
<i>Howell:</i>			
J.A.K. Co.	$\frac{180}{900} \times 139,524.00 =$	27,904.80	
Kenyon	$\frac{100}{900} \times 139,524.00 =$		15,502.67
Total J.A.K. Co.		<hr/> \$117,820.08	
Total Kenyon			<hr/> \$61,341.84

Assuming J.A.K. Co. to have had no other income, its tax on these dividends would have been:

### *Federal Normal and Surtax:*

Net income	\$117,820.08
Less: Dividends received credit	100,147.07 (a)
Total subject to normal and surtax	<hr/> \$17,673.01
Tax: On first 5,000 —	\$1,050.00
" next 12,673.01	2,914.79
Total normal and surtax	<hr/> \$3,964.79 (b)

J.A.K. Co. would, therefore, have been able to pay to Mr. Kenyon a dividend in an amount equal to the difference between the total dividends received by it from the three corporations and the taxes payable upon such dividends:

Total dividends received	\$117,820.08
Taxes payable thereon	3,964.79
	<hr/>
Available for distribution to Mr. Kenyon	\$113,855.29

The dividends received by Mr. Kenyon from the three corporations and from J.A.K. Co. would have been taxable income to him and would have been in addition to his other income for the year, making him subject to Federal and California income taxes as follows:

*Federal Tax:*

Net income from all sources other than dividends from the three corporations and J.A.K. Co. (R. 193)	\$106,429.40
Dividends from the three corporations	61,341.84
Dividends from J.A.K. Co.	113,855.29
	<hr/>
Total taxable net income	\$281,626.53
Personal exemption and credit for dependents	1,200.00 (e)
	<hr/>
Subject to tax	\$280,426.53

*Tentative Normal and Surtax:*

On \$200,000	\$156,820.00
On \$80,426.53 @ 91%	73,188.14
Total tentative tax	\$230,008.14 (f)

*1948 Reduction:*

On \$100,000	\$12,020.00	
On 130,008.14 @ 9.75%	12,675.79	24,695.79 (g)
	<hr/>	<hr/>
Total normal and surtax after reduction		\$205,312.35
Limited to 77% of \$281,626.53		216,852.43 (h)
Total Federal tax payable		205,312.35

*California Tax:*

Total net income per Federal	\$281,626.53
Add: 1947 California income tax not deductible	972.77 (i)
California net taxable income	\$282,599.30
Personal exemption and credit for dependents	3,400.00 (j)
Subject to tax	\$279,199.30
Tax on first \$30,000.00	\$ 800.00
Tax on 249,199.30 @ 6%	14,951.96
	\$15,751.96 (k)

RECAP:

Federal tax payable	\$205,312.35
California tax payable	15,751.96
Total	\$221,064.31

The maximum amount available to Mr. Kenyon to apply to the purchase price of the trust shares would be the excess of his total net income for the year, including the dividends from the three corporations and J.A.K. Co., over his total taxes payable for the year:

Total net income	\$281,626.53
Total taxes payable	221,064.31
Available to apply to purchase	\$ 60,562.22

CONCLUSION:

Total purchase price of trust shares	\$196,366.80
Amount available to apply to purchase price	60,562.22
Shortage	\$135,804.58

(Notes (a) through (k): See Appx. p. 21 for statutory authority for factors used.)

**Proof of the Fact That It Would Have Been Impossible for the Three Corporations to Have Paid Ordinary Dividends in an Amount Sufficient to Enable James A. Kenyon to Pay the Purchase Price of 130 Shares of Capitol Chevrolet Co. Stock, 130 Shares of Mid-Valley Chevrolet Co. Stock and 100 Shares of Howell Chevrolet Co. Stock if He Had Purchased Said Shares Directly From the Trust.**

*Factors:*

(1) The purchase price to be paid for the trust shares would have been the same as the redemption price: *i. e.*,

130 sh. Capitol Chevrolet Co. —	\$ 75,518.30
130 " Mid-Valley Chevrolet Co. —	74,340.50
100 " Howell Chevrolet Co. —	46,508.00
	<hr/>
	\$196,366.80 (R. 19, 20)

(2) The corporate earned surpluses which would have been available for payment of ordinary dividends if the redemptions had not been made would have been:

*Capitol Chevrolet Co.*

Actual surplus at 12-31-48	
[Ex. 21-V, Appx. p. 57]	\$285,666.90
Total amount distributed in redemption	\$151,036.60 [R. 19]
Portion of redemption distribution charged to capital	26,000.00
	<hr/>
Portion of redemption distribution charged to surplus	125,036.60
[Ex. 21-V, Sched. L; Appx. p. 57]	125,036.60
	<hr/>
Earned surplus which would have been on hand if redemption had not been made	\$410,703.50



*Mid-Valley Chevrolet Co.:*

Actual surplus at 12-31-48		
[Ex. 16-P, Appx. p. 54]		\$275,536.12
Total amount distributed in redemption	\$148,681.00 [R. 20]	
Portion of redemption distribution charged to capital	26,000.00	
	<hr/>	
Portion of redemption distribution charged to surplus	122,681.00	
[Ex. 16-P, Sched. L; Appx. p. 54]		122,681.00
		<hr/>
Earned surplus which would have been on hand if redemption had not been made		\$398,217.12

*Howell Chevrolet Co.*

Actual surplus at 12-31-48		
[Ex. 11-K, Appx. p. 51]		\$223,970.73
Total amount distributed in redemption	\$139,524.00 [R. 20]	
Portion of redemption distribution charged to capital	30,000.00	
	<hr/>	
Portion of redemption distribution charged to surplus	109,524.00	109,524.00
[Ex. 11-K, Sched. L; Appx. p. 51]		<hr/>
Earned surplus which would have been on hand if redemption had not been made		\$333,494.73

(3) If James A. Kenyon, personally, had purchased 130 shares of Capitol Chevrolet Co., 130 shares of Mid-Valley Chevrolet Co. and 100 shares of Howell Chevrolet Co. from the Trust, and if following such purchase the corporations had paid out, as ordinary dividends, their *entire* earned surpluses which would then have been on hand, J.A.K. Co. and James A. Kenyon would have received the following dividends:

<u>Capital Chevrolet Co.</u>	<u>J.A.K. Co.</u>	<u>James A. Kenyon</u>
J.A.K. Co.: $\frac{255}{850} \times 410,703.50 =$	123,211.05	
Kenyon: $\frac{130}{850} \times 410,703.50 =$		62,813.48
<i>Mid-Valley Chevrolet Co.</i>		
J.A.K. Co.: $\frac{255}{850} \times 398,217.12 =$	119,465.14	
Kenyon: $\frac{130}{850} \times 398,217.12 =$		60,903.79
<i>Howell Chevrolet Co.</i>		
J.A.K. Co.: $\frac{180}{900} \times 333,494.73 =$	66,698.95	
Kenyon: $\frac{100}{900} \times 333,494.73 =$		37,054.97
Total Received by J.A.K. Co.	<u>\$309,375.14</u>	
Total Received by James A. Kenyon		<u>\$160,772.24</u>

(4) If J.A.K. Co. had no income other than the dividends which it would have received from the three corporations it would have been able to pay a dividend to James A. Kenyon equal to the entire amount of such dividends so received by it less the Federal income tax due on the amount so received:

Net Income	\$309,375.14
Less: Dividend received credit	262,968.87 (a)
Total taxable	<u>46,406.27</u>
Tax: On First \$5,000	1,050.00
On Next 15,000	3,450.00
On Next 5,000	1,250.00
On Next 21,406.27	<u>11,345.32</u>
TOTAL TAX	<u>\$17,095.32 (b)</u>
Total Dividends received	309,375.14
Federal tax thereon	<u>17,095.32</u>
Available for distribution to James A. Kenyon	<u>\$292,279.82</u>

(5) The dividends received by James A. Kenyon from the three corporations and from J.A.K. Co. would have been taxable income to him and would have been in addition to his other income for the year, making him subject to Federal and California income taxes as follows:

*Federal Tax*

Net income from all sources other than dividends from the three corporations and J.A.K. Co. [R. 193]	\$106,429.40
Dividends from the three corporations	160,772.24
Dividend from J.A.K. Co.	292,279.82
	<hr/>
Total Net Taxable income	559,481.46
Personal Exemption and Credit for dependents	1,200.00 (e)
	<hr/>
Subject to tax:	558,281.46
Tentative Normal Tax and Surtax:	
On \$200,000	156,820.00
On \$358,281.46 at 91%	326,036.13
	<hr/>
Total Tentative tax	\$482,856.13 (f)
1948 Reduction:	
On \$100,000	12,020.00
On \$382,856.13 @ 9.75%	37,328.47
	<hr/>
Total Normal and Surtax after reduction	\$433,507.66
Limited to 77% of \$559,481.46 =	430,800.72
Total Federal tax payable =	\$430,800.72

*California Tax*

Total net taxable income per Federal	559,481.46
Add: 1947 California income tax is not deductible	972.77 (i)
	<hr/>
California Net Taxable Income	560,454.23
Personal exemption and credit for dependents	3,400.00 (j)
	<hr/>
Subject to Tax	557,054.23
Tax on first \$30,000.00	\$ 800.00
Tax on \$527,054.23 @ 6%	31,623.25 (k)
	<hr/>
Total California Tax	32,423.25
Recap:	
Federal tax payable	\$430,800.72
California tax payable	32,423.25
	<hr/>
Total taxes payable for year	\$463,223.97

(6) The maximum amount available to James A. Kenyon for use in paying the purchase price of the shares purchased from the Trust would be his net taxable income received from all sources during the year less the Federal and California income taxes payable for such year:

Total net income from all sources	\$559,481.46
Total Federal and California income taxes payable	463,223.97
	<hr/>
Maximum available for payment of purchase price of Trust shares	\$ 96,257.49

### Conclusion.

Since the purchase price of the Trust shares would have been \$196,366.80 and since the total amount, including his *entire* income from all sources, which James A. Kenyon would have been able to apply to such purchase if the three corporations had paid out every penny of their earned surpluses as ordinary dividends would have been only \$96,257.49, it follows that it would have been *impossible* for the three corporations to have paid ordinary dividends in an amount sufficient for James A. Kenyon to pay the purchase price of such shares.

(Notes (a) through (k)—See Appx. p. 21 for statutory authority for factors used.)

## Statutory Authority for Factors Used in Computations.

<u>Note</u>	<u>Factor in Computation</u>	<u>Applicable Statute</u>
(a)	Dividends Received Credit	IRC 1939, Sec. 26(b)
(b)	Normal and Surtax Rates (Corporation)	IRC 1939, Sec. 12(b) as amended by Sec. 104 of the Revenue Act of 1948
(c)	Undistributed Net Income	IRC 1939, Secs. 504, 505
(d)	Personal Holding Company Surtax Rates	IRC 1939, Sec. 500 as amended by Sec. 181 of the Revenue Act of 1942
(e)	Personal exemption and credit for dependents (Federal)	IRC 1939, Sec. 25(b) as amended by Sec. 201 of the Revenue Act of 1948
(f)	Tentative Normal and Surtax Rates (Individual)	IRC 1939, Sec. 12(a) and (b) as amended by Sec. 104 of the Rev- enue Act of 1948.
(g)	1948 Reduction	IRC 1939, Sec. (c)(1) as amend- ed by Sec. 104 of the Internal Revenue Code of 1948
(h)	Limitation on Tax	IRC 1939, Sec. (c)(2) as amend- ed by Sec. 104 of the Revenue Act of 1948
(i)	California income tax not deductible	Revenue and Taxation Code of the State of California, Sec. 17305
(j)	Personal exemption and credit for dependents (California)	Revenue and Taxation Code of the State of California, Sec. 17951 and Sec. 19201.5 as amend- ed by Chap. 12, Laws 1948
(k)	Tax Rates (California)	Revenue and Taxation Code of the State of California, Sec. 19200 as amended by Chap. 12, Laws 1948



## Joint Exhibit 4-D.

### DECLARATION OF TRUST

James A. Kenyon, hereinafter called "Trustee", hereby declares that he, with the written consent of his wife, Matilda R. Kenyon, has made a gift to his adopted daughter, Patricia May Kenyon, in trust, upon the terms and conditions hereinafter stated, and that he as "Trustor" has transferred and delivered to himself as "Trustee", without consideration other than the said gift, all right, title and interest in and to the properties described as: Two Hundred (200) shares of the Common Capital Stock of Mid-Valley Chevrolet Co., a California corporation, Valued at Twenty-five Thousand (\$25,000.00) Dollars.

All property now, or hereafter subject to this trust shall constitute the Trust Estate and shall be held, managed and distributed as hereinafter provided.

### ARTICLE I.

DISTRIBUTION OF INCOME AND PRINCIPAL	(1) The net income shall be distributed in annual or other convenient installments, as may be determined by the Trustee to or for the benefit of the said Patricia May Kenyon, hereinafter called the "Beneficiary" until she shall have reached the age of twenty-five (25) years. Her fourteenth birthday will be September 19, 1941.
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During her minority, the said net income shall be paid to her guardian and no part thereof shall be used for her maintenance or support so long as she is a minor, excepting only by order of a Court of Probate or general jurisdiction, having jurisdiction of her guardian. After she shall have reached her ma-

jority, the said net income shall be paid directly to the said Beneficiary.

(2) When the said Beneficiary shall have reached the age of twenty-five (25) years, one-half ( $\frac{1}{2}$ ) of the corpus of the Trust Estate, together with all accumulated income, if any, shall be distributed to the said Beneficiary. The remaining one-half ( $\frac{1}{2}$ ) shall be held by the Trustee subject to the terms of this Trust and the net income therefrom shall be paid to the said Beneficiary in annual, or other convenient, installments until she shall have reached the age of thirty-five (35) years, at which time the remaining corpus of the estate together with all undistributed net income shall be distributed to the said Beneficiary.

(3)—(a) If the Beneficiary should die before becoming entitled to receive distribution of the entire Trust Estate, and if she shall have lawful children, then the net income from the undistributed remainder of the Trust Estate shall be distributed in annual, or other convenient, installments, to or be used for the benefit of the lawful child of the Beneficiary, if there be only one child and if more than one to them in equal shares, and if any of such children shall then be dead but shall leave issue, then his or her share shall go to such issue, and if there be more than one such issue, to them in equal shares; if any such child of the Beneficiary shall be dead at the time of the death of the Beneficiary and shall not leave issue, then his or her share shall go to augment the shares of the living children and the issue of any deceased child on the principle of representation, until such child of the Beneficiary (if there be only one, or until the youngest of such children if there be more than one) has reached the age of twenty-one (21)

years, or until twenty-five (25) years after the date of this Trust, which ever occurs first; whereupon the undistributed corpus and accumulated income, if any, shall be distributed to such living children in equal shares and to the issue of any deceased child by right of representation; and thereupon this Trust shall cease and determine.

(b) If the said Beneficiary shall die without leaving lawful children or the issue of any deceased child or children, then the undistributed corpus, together with all accumulated and undistributed income, if any, shall be distributed as follows: One-half ( $\frac{1}{2}$ ) thereof to Mary Haydee Zelaya, grand-daughter of the wife of the Trustor, one-fourth ( $\frac{1}{4}$ ) to Nan Perry and one-fourth ( $\frac{1}{4}$ ) thereof to Gail Perry, the latter two being nieces of the Trustor. If the said Mary Haydee Zelaya shall not be living at the time she would be entitled to such distribution, then her share shall be divided equally between the said Nan Perry and the said Gail Perry. If either the said Nan Perry and the said Gail Perry shall not then be living, then her share shall be divided three-fourths ( $\frac{3}{4}$ ) to the said Mary Haydee Zelaya and one-fourth ( $\frac{1}{4}$ ) to the survivor of the two said nieces, and if any two of the three shall then be dead, then the entire undistributed corpus and accumulated income, if any, shall be distributed to the survivor of the three. If all three shall predecease the said Beneficiary, then the undistributed corpus and accumulated net income, if any, shall be distributed to the then living heirs at law of the said Beneficiary, Patricia May Kenyon, determined according to the laws of California then in force relating to separate property, and thereupon this Trust shall cease and terminate.

(4) Upon the decease of the said Patricia May Kenyon, or after her death, upon the decease of any person receiving income from the Trust Estate, the Trustee shall pay out of income, if available, and if not available then out of principal, her or his last illness and burial expenses to the extent that these items shall not be paid by some other person or estate.

## ARTICLE II

POWERS OF THE TRUSTEE      To carry out the purposes of this Trust and subject to any limitations stated elsewhere in this Declaration, the Trustee is vested with the following powers, in addition to those now or hereafter conferred by law, affecting the Trust and the Trust Estate:

(1) To hold any property and operate any business received in this Trust as long as he may deem advisable.

(2) To manage, control, sell, convey, exchange, partition, divide, subdivide, improve, repair; to grant options and to sell upon deferred payments; to lease for terms within or extending beyond the duration of this Trust for any purpose, including exploration for and removal of gas, oil and other minerals; to create restrictions, easements and other servitudes.

(3) To compromise, arbitrate or otherwise adjust claims in favor of or against the Trust; to carry such insurance as the Trustee may deem advisable.

(4) To invest principal, and income if accumulated, in such bonds, mortgages, trust deeds, debentures, preferred or common stocks, or other property, real or personal, as the Trustee may deem advisable, whether or not authorized by law for the investment

of trust funds. The Trustee shall not be liable for any loss of principal or income which may result from the making of any such investments.

(5) To advance funds to this Trust for any trust purpose, such advances with interest at current rates to be a first lien on and to be repaid out of principal or income; to reimburse himself from principal or income for any loss or expense incurred by reason of his ownership or holding of any property in this Trust.

(6) To borrow money for any trust purpose upon such terms and conditions as the Trustee may deem proper, and to obligate the Trust Estate for repayment; to encumber the Trust Estate or any of its property by mortgage, deed of trust, pledge or otherwise, using such procedure to consummate the transaction as the Trustee may deem advisable.

(7) To have respecting securities all the rights, powers and privileges of an owner, including the power to give proxies, pay assessments and other sums deemed by the Trustee necessary for the protection of the Trust Estate; to participate in voting trusts, pooling agreements, foreclosures, reorganizations, consolidations, mergers and liquidations, and in connection there with to deposit securities with and transfer title to any protective or other committee under such terms as the Trustee may deem advisable; to exercise or sell stock subscription or conversion rights; regardless of any limitations elsewhere in this instrument relative to investments by the Trustee, to accept and retain as an investment any securities or other property received through the exercise of any of the foregoing powers.



(8) Upon any division or partial or final distribution of the Trust Estate, to partition, allot and distribute the Trust Estate in undivided interests or in kind, or partly in money and partly in kind, at valuations determined by the Trustee, and to sell such property as the Trustee may deem necessary to make division or distribution.

(9) To budget the estimated annual income and expenses of the Trust in such manner as to equalize, as far as practicable, periodical income payments to beneficiaries.

(10) To determine what is principal or income of the Trust Estate and apportion and allocate in his discretion receipts and expenses as between these accounts.

(11) Unless specifically limited, all discretions conferred upon the Trustee shall be absolute and their exercise conclusive on all persons interested in this Trust. The enumeration of certain powers of the Trustee shall not limit his general powers, the Trustee being vested with and having all the rights, powers, and privileges which an absolute owner of the same property would have.

### ARTICLE III.

GENERAL PROVISIONS (1) Income accrued or unpaid on trust property when received into the trust shall be treated as any other income. Income accrued or held undistributed by the Trustee at the termination of any interest or estate under this Trust shall go to the beneficiaries entitled to the next eventual interest in the proportions in which they take such interest. Periodical payments out of principal,

not due upon the termination of any interest or estate, shall not be apportioned to that date. The Trustee shall not be required to prorate taxes and other current expenses to the date of termination.

(2) Until the Trustee shall receive written notice of any birth, marriage, death or other event upon which the right to payments from this Trust may depend, the Trustee shall incur no liability for disbursements made in good faith to persons whose interests may have been affected by that event.

(3) The Trustee may make payments to any beneficiary under disability by making them to the guardian of the person of the beneficiary or directly to the beneficiary, if a minor, or may apply them for the beneficiary's benefit.

SUCCESSOR (4) The Trustee shall have the right to  
TO TRUSTEE resign this Trusteeship at any time and to substitute a successor or successors by executing a written substitution; such substitution shall contain appropriate reference to this Declaration of Trust and the name of the new Trustee and the same shall be effective upon the signature of the Trustee and the acceptance in writing by the new Trustee, a copy of such substitution shall be delivered to or mailed to each beneficiary then entitled to receive income from the Trust Estate. From the time the substitution is signed, as aforesaid, the new Trustee shall succeed to all of the powers, duties, authority and title to the Trustee herein named. The procedure herein provided for substitution of Trustee shall be exclusive of all other provisions for substitution, statutory or otherwise.

MISCELLANEOUS (5) This Trust is irrevocable. The  
PROVISIONS Trustor may amend this Trust only in-  
sofar as it shall affect the powers,  
duties, and responsibilities of the Trustee, and may  
cancel or amend any such amendment. No amend-  
ment shall invest the Trustor with power to revoke  
this Trust in whole or in part, or to provide for any  
portion of the income to be distributed to or for the  
benefit of the Trustor, and no amendment shall be  
made which might result in a reverter or possibility  
of reverter of any portion of the corpus or income  
of the Trust Estate to the Trustor.

(6) If the Trustee shall be required to pay any  
gift or estate taxes in connection with this Trust,  
the same may be charged against income or principal  
or both as the Trustee in his sole discretion may de-  
termine is to the best interests of the Trust Estate.  
The Trust herein created shall, unless sooner ter-  
minated, by the distribution of all principal and ac-  
cumulated income as herein provided, expire and de-  
termine twenty-five (25) years after the date of this  
Trust. The situs of this Trust shall be the State of  
California and the same shall be construed according  
to the laws of the State of California.

(7) If any provision of this instrument is unen-  
forceable, the remaining provisions shall, nevertheless,  
be carried into effect.

(8) Other property acceptable to the Trustee may  
be added to this Trust.

EXECUTED this 8th day of August, 1941.

-----  
TRUSTEE

I certify that I have read the foregoing Declaration of Trust and approve the same in all particulars and request the Trustee to execute it.

.....  
TRUSTOR

I, Matilda R. Kenyon, wife of the Trustor, do hereby certify that the foregoing has been executed with my knowledge and consent.

.....

Joint Exhibit 5-E

MINUTES OF THE MEETING OF DIRECTORS  
OF  
CAPITOL CHEVROLET Co.

Held December 21, 1948

At a meeting of the Board of Directors of Capitol Chevrolet Co., a California corporation, held at 5117 Proctor, Oakland, California on December 21, 1948, the following members were present:

F. Norman Phelps

James A. Kenyon

Alice Phelps

being all of the Directors of this company. Mr. Phelps acted as Chairman of the meeting and Mrs. Phelps acted as Secretary thereof.

The minutes of the previous meeting were read and upon motion duly made and seconded were unanimously approved.

The President stated that the Chevrolet Division of General Motors Corporation had advised this corporation by letter that it would have to eliminate the Patricia May Kenyon Trust as a stockholder in order to maintain its franchise; that the policy of the Chevrolet Division was to require the shareholders of enfranchised corporations to be active in the business and that the continuation of said Trust as a stockholder contravened that policy. He stated further that in conversation with the Chevrolet Division of General Motors the Division had acknowledged the success achieved by Messrs. Phelps and Kenyon in their previous operations where control had been divided equally between them and it urged that the elimination of the Trust



be so achieved that control of this corporation thereafter remain equally divided between Messrs. Phelps and Kenyon. He said that in order to satisfy those requirements, the possible purchasers of the Trust's stock were necessarily limited to the present stockholders and the corporation; that no one of them was financially able at this time to purchase all of the Trust's stock and so much in addition as might be necessary to equalize the interests of Messrs. Phelps and Kenyon; that considerable study had been given to ways and means of satisfying the demands of the Chevrolet Division of General Motors Corporation within the latitude permitted by the finances of the stockholders and this corporation and that a plan had been informally agreed upon whereby the corporation would purchase from the Trust 130 shares at the book value thereof determined as of November 30, 1948 and that Mr. Kenyon would purchase from said Trust the remaining 40 shares; provided, however, that upon application duly made by Mr. Kenyon in his personal capacity the Superior Court having jurisdiction grants him permission to purchase said shares from the Trust; that in order to equalize stock ownership between Messrs. Kenyon and Phelps the corporation would thereafter purchase from F. Norman and Alice Phelps 130 shares, thus making the voting control equally divided between Messrs. Kenyon and Phelps. In the event that Mr. Kenyon is unable, upon application, to obtain court authorization for the purchase of the remaining 40 shares held by the Trust, then and in that event said shares will be purchased and retired by the corporation, and Mr. Kenyon will purchase from F. Norman and Alice Phelps 20 shares. After a general discussion of the foregoing, the following resolutions were unanimously adopted:

WHEREAS this corporation has been notified by the Chevrolet Division of General Motors Corporation

that it must eliminate the Patricia May Kenyon Trust as a stockholder of this corporation in order to maintain its franchise; and

WHEREAS this corporation has been further advised by the Chevrolet Division of General Motors Corporation that the voting control of this corporation should be equally divided between Messrs. Kenyon and Phelps; and

WHEREAS it is deemed to be to the best interests of this corporation that its stated capital be reduced from \$85,000 to \$59,000, upon its purchase of said 260 shares, or that it be reduced from \$85,000 to \$55,000 in the event that it is required to purchase 300 shares of said stock as more fully hereafter appears; and

WHEREAS the Board of Directors believe that the purchase of the stock of this corporation hereinafter referred to will not impair this corporation's ability to pay its debts and liabilities when they fall due; and

WHEREAS none of the stock outstanding of this corporation has liquidation preferences which may be prejudiced by this corporation's purchase of said stock; and

WHEREAS it is the opinion of the Board of Directors that the book value determined as of November 30, 1948 is also the fair market value of the stock of this corporation; and

WHEREAS the book value of one share of stock so determined as of November 30, 1948 is \$580.91;

NOW, THEREFORE, BE IT RESOLVED that the plan for the purchase and retirement by this corporation of 130 shares of this corporation's stock now held

by James Kenyon, Trustee for Patricia May Kenyon, for the purchase by James Kenyon of the remaining 40 shares held in said Trust, and for the purchase and retirement by this corporation of 130 shares from F. Norman and Alice Phelps, be and the same hereby is approved, it being understood that if court approval is not given to Mr. Kenyon to purchase the remaining 40 shares held by the Trust, then and in that event said 40 shares shall be purchased and retired by the corporation, and Mr. Kenyon will purchase from F. Norman and Alice Phelps 20 shares of stock.

BE IT FURTHER RESOLVED that the officers and directors, or any of them, is hereby authorized and directed to purchase out of earned surplus for and in behalf of this corporation 130 shares of this corporation's stock now held by James Kenyon, Trustee for Patricia May Kenyon Trust, for \$75,518.30.

BE IT FURTHER RESOLVED that the officers and directors, or any of them, is hereby authorized to purchase out of earned surplus for and in behalf of this corporation 130 shares of the stock now held by F. Norman Phelps and Alice Phelps for \$75,518.30.

BE IT FURTHER RESOLVED that in the event the Superior Court having jurisdiction refuses upon application to authorize the purchase by James Kenyon of 40 shares held by him as Trustee for Patricia May Kenyon, the officers and directors of this corporation be and the same hereby are directed to purchase said 40 shares for and in behalf of this corporation for \$23,236.40.

BE IT FURTHER RESOLVED that following the acquisition by this corporation of said shares of this

corporation's stock as detailed hereinabove, the officers and directors be and the same hereby are authorized to take such steps as may be necessary under Section 348 of the California Civil Code, to retire said shares and to accomplish a reduction of this corporation's stated capital from \$85,000 to \$59,000 in the event 260 of said shares are purchased or from \$85,000 to \$55,000 in the event 300 of said shares are purchased.

BE IT FURTHER RESOLVED that the officers of this corporation be and they hereby are authorized and directed to procure the approval of these resolutions by the vote or written consent of the holders of a majority of the outstanding shares of this corporation, regardless of limitations or restrictions of the voting rights thereof, and to take such further action as may be necessary and proper to effect the reduction of stated capital of this corporation, as hereinabove in these resolutions set forth and in accordance with the laws of the State of California.

After consideration and a general discussion of the corporation's financial statement, the following resolution was also unanimously adopted:

WHEREAS the purchase and redemption of stock according to the plan hereinabove set forth will reduce the corporation's working capital below its minimum requirements;

NOW, THEREFORE, BE IT RESOLVED that the officers of this corporation be and they hereby are authorized and directed to borrow, in behalf of this corporation, from such banks or trust companies as they may in their judgment determine, an amount not exceeding

\$200,000, for such period of time and upon such terms and rate of interest as may to them in their discretion seem advisable and to execute notes in respect thereto in the name of the corporation for the payment of the amount so borrowed.

Approved, ratified and confirmed by the Directors, this 21st day of December, 1948.

F. NORMAN PHELPS

F. Norman Phelps

JAMES A. KENYON

James A. Kenyon

ALICE PHELPS

Alice Phelps



## Joint Exhibit 6-F

### MINUTES OF THE MEETING OF THE BOARD OF DIRECTORS OF

MID-VALLEY CHEVROLET Co.

Held December 21, 1948

At a meeting of the Board of Directors of Mid-Valley Chevrolet Co., a California corporation, held at 5117 Proctor, in the City of Oakland, California on December 21, 1948, the following members were present:

F. Norman Phelps

James A. Kenyon

Absent:

James E. Carpenter

Mr. Phelps acted as Chairman of the meeting and Mr. Kenyon acted as Secretary thereof. The minutes of the previous meeting were read and upon motion duly made and seconded were unanimously approved.

The President stated that the Chevrolet Division of General Motors Corporation had advised this corporation by letter that it would have to eliminate the Patricia May Kenyon Trust as a stockholder in order to maintain its franchise; that the policy of the Chevrolet Division was to require the shareholders of enfranchised corporations to be active in the business and that the continuation of said Trust as a stockholder contravened that policy. He stated further that in conversations with him the Chevrolet Division had acknowledged the success achieved by Messrs. Phelps and Kenyon in their previous operations where control had been divided equally between them and it urged that the elimination of the Trust be so achieved that control of this corporation thereafter remain equally divided

between Messrs. Phelps and Kenyon. He said that in order to satisfy those requirements, the possible purchasers of the Trust's stock were necessarily limited to the present stockholders and the corporation; that no one of them was financially able at this time to purchase all of the Trust's stock and so much in addition as might be necessary to equalize the interests of Messrs. Phelps and Kenyon; that considerable study had been given to ways and means of satisfying the demands of the Chevrolet Division of General Motors Corporation within the latitude permitted by the finances of the stockholders and this corporation and that a plan had been informally agreed upon whereby the corporation would purchase from the Trust 130 shares at the book value thereof determined as of November 30, 1948 and that Mr. Kenyon would purchase from said Trust the remaining 40 shares; provided, however, that upon application duly made by Mr. Kenyon in his personal capacity the Superior Court having jurisdiction grants him permission to purchase said shares from the Trust; that in order to equalize stock ownership between Messrs. Kenyon and Phelps the corporation would thereafter purchase from F. Norman and Alice Phelps 130 shares, thus making the voting control equally divided between Messrs. Kenyon and Phelps. In the event that Mr. Kenyon is unable, upon application, to obtain court authorization for the purchase of the remaining 40 shares held by the Trust, then and in that event said shares will be purchased and retired by the corporation, and Mr. Kenyon will purchase from F. Norman and Alice Phelps 20 shares. After a general discussion of the foregoing, the following resolutions were unanimously adopted:

WHEREAS this corporation has been notified by the Chevrolet Division of General Motors Corporation

that it must eliminate the Patricia May Kenyon Trust as a stockholder of this corporation in order to maintain its franchise; and

WHEREAS this corporation has been further advised by the Chevrolet Division of General Motors Corporation that the voting control of this corporation should be equally divided between Messrs. Kenyon and Phelps; and

WHEREAS it is deemed to be the best interests of this corporation that its stated capital be reduced from \$85,000 to \$59,000, upon its purchase of said 260 shares, or that it be reduced from \$85,000 to \$55,000 in the event that it is required to purchase 300 shares of said stock as more fully hereafter appears; and

WHEREAS the Board of Directors believe that the purchase of the stock of this corporation hereinafter referred to will not impair this corporation's ability to pay its debts and liabilities when they fall due; and

WHEREAS none of the stock outstanding of this corporation has liquidation preferences which may be prejudiced in this corporation's purchase of said stock; and

WHEREAS it is the opinion of the Board of Directors that the book value determined as of November 30, 1948 is also the fair market value of the stock of this corporation; and

WHEREAS the book value of one share of stock so determined as of November 30, 1948 is \$571.85;

NOW, THEREFORE, BE IT RESOLVED that the plan for the purchase and retirement by this corporation of 130 shares of this corporation's stock now held

by James Kenyon, Trustee for Patricia May Kenyon, for the purchase by James Kenyon of the remaining 40 shares held in said Trust, and for the purchase and retirement by this corporation of 130 shares from F. Norman and Alice Phelps, be and the same hereby is approved, it being understood that if court approval is not given to Mr. Kenyon to purchase the remaining 40 shares held by the Trust, then and in that event said 40 shares shall be purchased and retired by the corporation, and Mr. Kenyon will purchase from F. Norman and Alice Phelps 20 shares of stock.

BE IT FURTHER RESOLVED that the officers and directors, or any of them, is hereby authorized and directed to purchase out of earned surplus for and in behalf of this corporation 130 shares of this corporation's stock now held by James Kenyon, Trustee for Patricia May Kenyon Trust, for \$74,340.50.

BE IT FURTHER RESOLVED that the officers and directors, or any of them, is hereby authorized to purchase out of earned surplus for and in behalf of this corporation 130 shares of the stock now held by F. Norman Phelps and Alice Phelps for \$74,340.50.

BE IT FURTHER RESOLVED that in the event the Superior Court having jurisdiction refuses upon application to authorize the purchase by James Kenyon of 40 shares held by him as Trustee for Patricia May Kenyon, the officers and directors of this corporation be and the same hereby are directed to purchase said 40 shares for and in behalf of this corporation for \$22,874.00.

BE IT FURTHER RESOLVED that following the acquisition by this corporation of said shares of this cor-

poration's stock as detailed hereinabove, the officers and directors be and the same hereby are authorized to take such steps as may be necessary under Section 348 of the California Civil Code, to retire said shares and to accomplish a reduction of this corporation's stated capital from \$85,000 to \$59,000 in the event 260 of said shares are purchased or from \$85,000 to \$55,000 in the event 300 of said shares are purchased.

BE IT FURTHER RESOLVED that the officers of this corporation be and they hereby are authorized and directed to procure the approval of these resolutions by the vote or written consent of the holders of a majority of the outstanding shares of this corporation, regardless of limitations or restrictions of the voting rights thereof, and to take such further action as may be necessary and proper to effect the reduction of stated capital of this corporation, as hereinabove in these resolutions set forth and in accordance with the laws of the State of California.

After consideration and a general discussion of the corporation's financial statement, the following resolution was also unanimously adopted:

WHEREAS the purchase and redemption of stock according to the plan hereinabove set forth will reduce the corporation's working capital below its minimum requirements;

NOW, THEREFORE, BE IT RESOLVED that the officers of this corporation be and they hereby are authorized and directed to borrow, in behalf of this corporation, from such banks or trust companies as they may in their judgment determine, an amount not exceeding



\$200,000, for such period of time and upon such terms and rate of interest as may to them in their discretion seem advisable and to execute notes in respect thereto in the name of the corporation for the payment of the amount so borrowed.

Approved, ratified and confirmed by the Directors, this 21st day of December, 1948.

F. NORMAN PHELPS

F. Norman Phelps

JAMES A. KENYON

James A. Kenyon

## Joint Exhibit 7-G

### MINUTES OF THE MEETING OF THE BOARD OF DIRECTORS OF

HOWELL CHEVROLET Co.

Held December 21, 1948

At a meeting of the Board of Directors of Howell Chevrolet Co., a California corporation, held at 5117 Proctor in the City of Oakland, California on December 21, 1948, the following members were present:

F. Norman Phelps

James A. Kenyon

Absent:

Jackson Howell

Mr. Phelps acted as Chairman and Mr. Kenyon acted as Secretary of the meeting.

The Secretary presented and read to the meeting a written Waiver of Notice thereof signed by all the Directors.

The minutes of the previous meeting were read and upon motion duly made and seconded were unanimously approved.

The President stated that the Chevrolet Division of General Motors Corporation had advised this corporation by letter that it would have to eliminate the Patricia May Kenyon Trust from stock ownership in the corporation in order for this corporation to retain its franchise; that the policy of the Chevrolet Division was to require the stockholders of enfranchised corporations to be active in the business and that the continuation of said Trust as a stockholder contravened that policy. He said that representatives of the Chevrolet Division had orally indicated that in view of the corporation's past success under own-

ership where the voting control of the corporation was equally divided among Messrs. Phelps, Kenyon and Howell there was no desire on its part to disturb that allocation; rather it thought it desirable that the elimination of the Trust be so accomplished that voting control of the corporation repose where it had prior to the elimination of the Trust. He said that in order to satisfy those requirements, the possible purchasers of the stock now held by the Trust were necessarily limited to the other present stockholders and the corporation; that Mr. Kenyon had advised him that he was not financially able to purchase all of the stock held by the Trust but that he could purchase some of it if he could obtain the necessary court approval; that in view of this and after considerable study of ways and means of satisfying the demands made by the Chevrolet Division, a plan had been informally agreed upon whereby the corporation would purchase from the Trust 100 shares of this corporation's stock, another 100 shares from Mr. Howell and an additional 100 shares from F. Norman and Alice Phelps. At the same time Mr. Kenyon would purchase 20 shares from the Trust, with the end result that after these purchases were made, Messrs. Phelps, Kenyon and Howell would each have voting control of 200 shares of the stock of this corporation. It is contemplated that the plan will be carried out as stated hereinabove. However, Mr. Kenyon must obtain authorization from the Superior Court of the State of California to purchase said 20 shares from the Trust of which he is trustee. In the event that he is denied such authority, then it is understood that the corporation will purchase from the Trust said 20 remaining shares and in that event F. Norman and Alice Phelps will sell to Mr. Kenyon  $6\frac{2}{3}$  shares, and Jackson Howell will likewise sell to Mr. Ken-

yon  $6\frac{2}{3}$  shares. After a general discussion of the foregoing, the following resolutions were unanimously adopted:

WHEREAS this corporation has been notified by the Chevrolet Division of General Motors Corporation that it must eliminate the Patricia May Kenyon Trust as a stockholder of this corporation in order to retain its franchise; and

WHEREAS this corporation has been further advised by the Chevrolet Division of General Motors Corporation that the voting control of this corporation should remain equally distributed among Messrs. Phelps, Kenyon and Howell; and

WHEREAS there are now outstanding 900 shares of \$100 par value common stock; and

WHEREAS the stated capital of this corporation is \$90,000; and

WHEREAS the Board of Directors believe that the purchase of the stock of this corporation hereinafter referred to will not impair this corporation's ability to pay its debts and liabilities when they fall due; and

WHEREAS none of the stock outstanding of this corporation has liquidation preferences which may be prejudiced by this corporation's purchase of said stock; and

WHEREAS the book value of one share of stock of this corporation determined as of November 30, 1948 is \$465.08; and

WHEREAS it is the opinion of the Board of Directors that said book value is also the fair market value of said stock; and

WHEREAS it is deemed to the best interests of this corporation that its stated capital be reduced from

\$90,000 to \$60,000 upon its purchase of said 300 shares of stock, or in the event that Mr. Kenyon is unable to obtain authority to purchase 20 shares of this corporation's stock from the Patricia May Kenyon Trust and this corporation, by reason thereof, is then required to purchase 320 shares of said stock, that the stated capital then be reduced from \$90,000 to \$58,000.

NOW, THEREFORE, BE IT RESOLVED that the plan for the purchase and retirement by this corporation of 100 shares of its common capital stock from the Patricia May Kenyon Trust of 100 shares from Jackson Howell and of 100 shares of said stock from F. Norman and Alice Phelps, together with the concurrent purchase by James A. Kenyon of 20 shares of said stock from the Patricia May Kenyon Trust, be and the same hereby is approved, it being understood that if James A. Kenyon is denied authority by the Superior Court to purchase said 20 shares, that then and in that event the corporation will purchase said shares and F. Norman and Alice Phelps will sell to James A. Kenyon  $6\frac{2}{3}$  shares, as will Jackson Howell.

BE IT FURTHER RESOLVED that the officers and directors, or any of them, is hereby authorized and directed to purchase out of earned surplus for and in behalf of this corporation 100 shares of this corporation's common capital stock now held by James A. Kenyon, Trustee for Patricia May Kenyon Trust, for \$46,508.00.

BE IT FURTHER RESOLVED that the officers and directors, or any of them, is hereby authorized to purchase out of earned surplus for and in behalf of



this corporation 100 shares of this corporation's common capital stock from Jackson Howell for \$46,508.

BE IT FURTHER RESOLVED that the officers and directors, or any of them, is hereby authorized to purchase out of earned surplus for and in behalf of this corporation 100 shares of this corporation's common capital stock from F. Norman and Alice Phelps for \$46,508.

BE IT FURTHER RESOLVED that in the event the Superior Court having jurisdiction refuses, upon application, to authorize the purchase by James Kenyon of 20 shares held by him as Trustee for Patricia May Kenyon, the officer and directors of this corporation, or any of them, is hereby authorized and directed to purchase said 20 shares for and in behalf of this corporation for \$9,316.

BE IT FURTHER RESOLVED that following the acquisition by this corporation of said shares of this corporation's stock, as detailed hereinabove, the officers and directors be and the same hereby are authorized to take such steps as may be necessary under Section 348 of the California Civil Code to retire said shares and to accomplish a reduction of this corporation's stated capital from \$90,000 to \$60,000 in the event that the corporation purchases 300 shares of said stock, or from \$90,000 to \$58,000 in the event that this corporation purchases 320 of said shares.

BE IT FURTHER RESOLVED that the officers of this corporation be, and they hereby are authorized and directed to procure the approval of these resolutions by the vote or written consent of the holders of a majority of the outstanding shares of this corpora-

tion, regardless of limitations or restrictions of the voting rights thereof, and to take such further action as may be necessary and proper to effect the reduction of stated capital of this corporation, as hereinabove in these resolutions set forth and in accordance with the laws of the State of California.

After consideration and a general discussion of the corporation's financial statement, the following resolution was also unanimously adopted:

WHEREAS the purchase and redemption of stock according to the plan hereinabove set forth will reduce the corporation's working capital below its minimum requirements;

NOW, THEREFORE, BE IT RESOLVED that the officers of this corporation be and they hereby are authorized and directed to borrow, in behalf of this corporation, from such banks or trust companies as they may in their judgment determine, an amount not exceeding \$200,000, for such period of time and upon such terms and rate of interest as may to them in their discretion seem advisable and to execute notes in respect thereto in the name of the corporation for the payment of the amount so borrowed.

Approved, ratified and confirmed by the Directors this 21 day of December, 1948.

F. NORMAN PHELPS

F. Norman Phelps

JAMES A. KENYON

James A. Kenyon

[illegible]

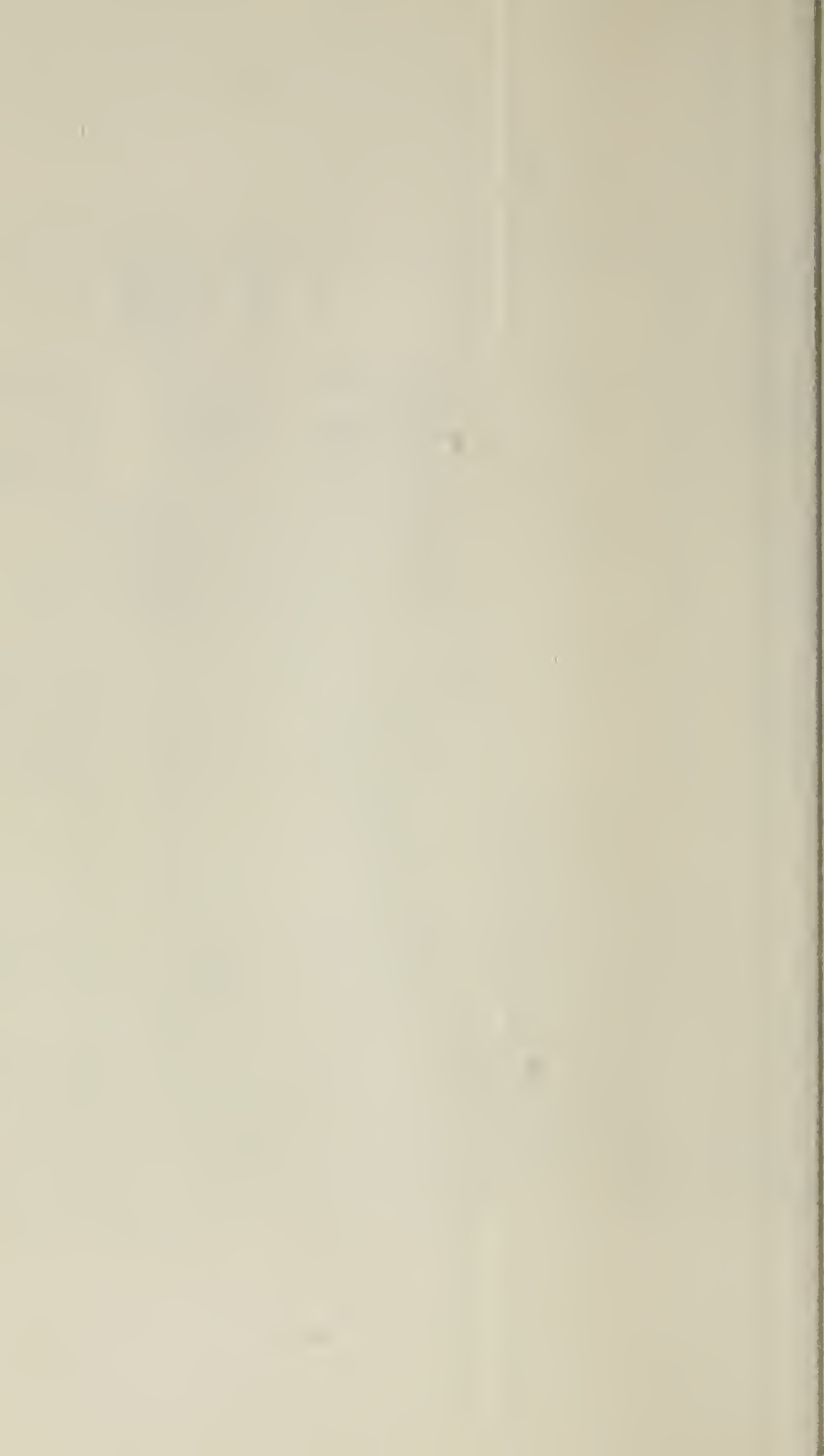










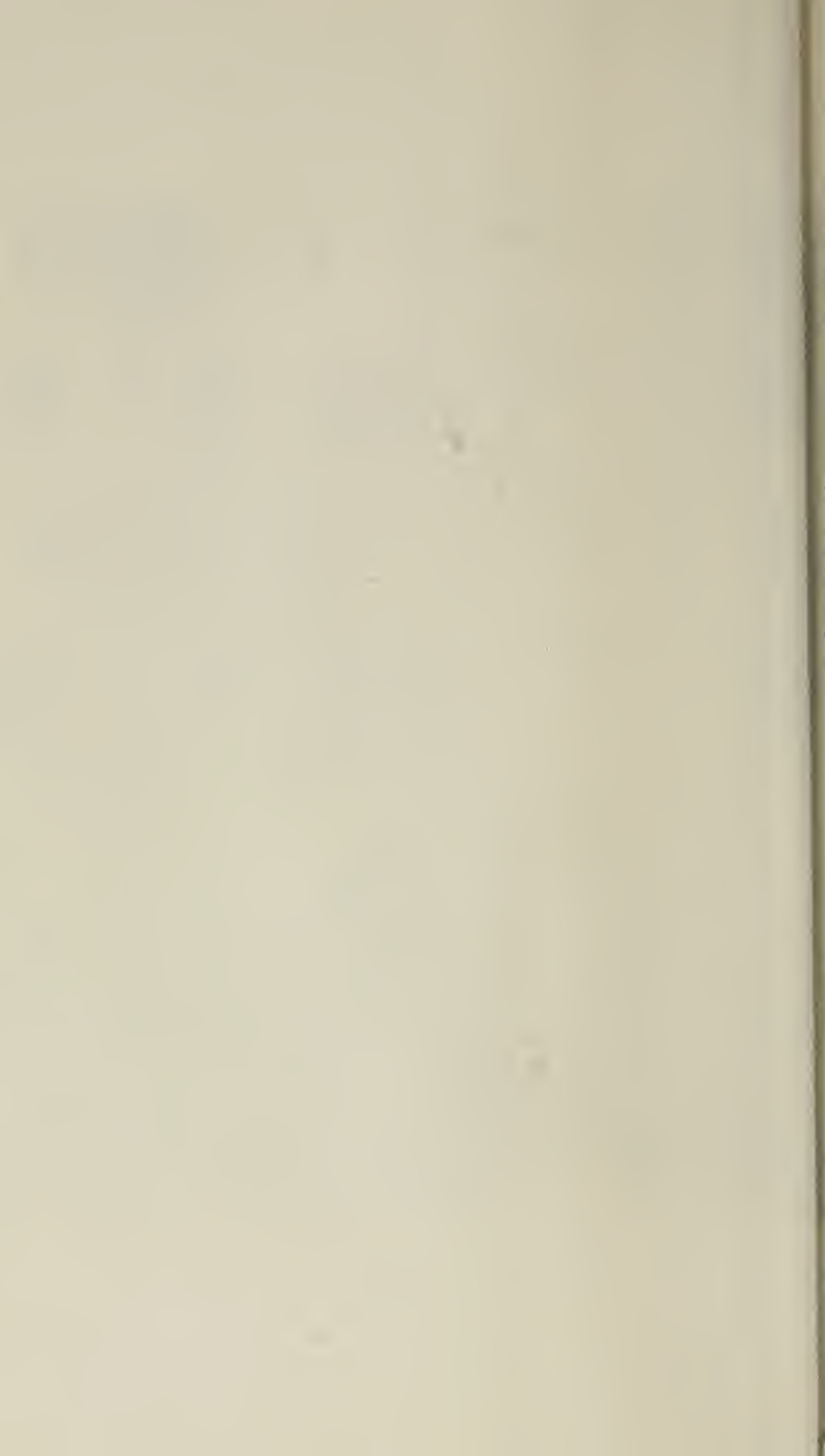


ASSETS		LIABILITIES		EQUITY	
1. Cash	\$ 151,533.13	1. Total	\$ 151,533.13	1. Capital stock	\$ 151,533.13
2. Notes and accounts receivable	\$ 29,378.91	2. Notes and accounts payable	\$ 29,378.91	2. Retained earnings	\$ 29,378.91
3. Inventories	\$ 26,292.12	3. Prepaid expenses	\$ 26,292.12	3. Other reserves	\$ 26,292.12
4. Investments	\$ 123,270.13	4. Other liabilities	\$ 123,270.13	4. Total	\$ 123,270.13
5. Total	\$ 293,474.29	5. Total	\$ 293,474.29		
6. Total	\$ 293,474.29	6. Total	\$ 293,474.29		
7. Total	\$ 293,474.29	7. Total	\$ 293,474.29		
8. Total	\$ 293,474.29	8. Total	\$ 293,474.29		
9. Total	\$ 293,474.29	9. Total	\$ 293,474.29		
10. Total	\$ 293,474.29	10. Total	\$ 293,474.29		
11. Total	\$ 293,474.29	11. Total	\$ 293,474.29		
12. Total	\$ 293,474.29	12. Total	\$ 293,474.29		
13. Total	\$ 293,474.29	13. Total	\$ 293,474.29		
14. Total	\$ 293,474.29	14. Total	\$ 293,474.29		
15. Total	\$ 293,474.29	15. Total	\$ 293,474.29		
16. Total	\$ 293,474.29	16. Total	\$ 293,474.29		
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24. Total	\$ 293,474.29	24. Total	\$ 293,474.29		
25. Total	\$ 293,474.29	25. Total	\$ 293,474.29		
26. Total	\$ 293,474.29	26. Total	\$ 293,474.29		
27. Total	\$ 293,474.29	27. Total	\$ 293,474.29		
28. Total	\$ 293,474.29	28. Total	\$ 293,474.29		
29. Total	\$ 293,474.29	29. Total	\$ 293,474.29		
30. Total	\$ 293,474.29	30. Total	\$ 293,474.29		
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32. Total	\$ 293,474.29	32. Total	\$ 293,474.29		
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35. Total	\$ 293,474.29	35. Total	\$ 293,474.29		
36. Total	\$ 293,474.29	36. Total	\$ 293,474.29		
37. Total	\$ 293,474.29	37. Total	\$ 293,474.29		
38. Total	\$ 293,474.29	38. Total	\$ 293,474.29		
39. Total	\$ 293,474.29	39. Total	\$ 293,474.29		
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64. Total	\$ 293,474.29	64. Total	\$ 293,474.29		
65. Total	\$ 293,474.29	65. Total	\$ 293,474.29		
66. Total	\$ 293,474.29	66. Total	\$ 293,474.29		
67. Total	\$ 293,474.29	67. Total	\$ 293,474.29		
68. Total	\$ 293,474.29	68. Total	\$ 293,474.29		
69. Total	\$ 293,474.29	69. Total	\$ 293,474.29		
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73. Total	\$ 293,474.29	73. Total	\$ 293,474.29		
74. Total	\$ 293,474.29	74. Total	\$ 293,474.29		
75. Total	\$ 293,474.29	75. Total	\$ 293,474.29		
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81. Total	\$ 293,474.29	81. Total	\$ 293,474.29		
82. Total	\$ 293,474.29	82. Total	\$ 293,474.29		
83. Total	\$ 293,474.29	83. Total	\$ 293,474.29		
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86. Total	\$ 293,474.29	86. Total	\$ 293,474.29		
87. Total	\$ 293,474.29	87. Total	\$ 293,474.29		
88. Total	\$ 293,474.29	88. Total	\$ 293,474.29		
89. Total	\$ 293,474.29	89. Total	\$ 293,474.29		
90. Total	\$ 293,474.29	90. Total	\$ 293,474.29		
91. Total	\$ 293,474.29	91. Total	\$ 293,474.29		
92. Total	\$ 293,474.29	92. Total	\$ 293,474.29		
93. Total	\$ 293,474.29	93. Total	\$ 293,474.29		
94. Total	\$ 293,474.29	94. Total	\$ 293,474.29		
95. Total	\$ 293,474.29	95. Total	\$ 293,474.29		
96. Total	\$ 293,474.29	96. Total	\$ 293,474.29		
97. Total	\$ 293,474.29	97. Total	\$ 293,474.29		
98. Total	\$ 293,474.29	98. Total	\$ 293,474.29		
99. Total	\$ 293,474.29	99. Total	\$ 293,474.29		
100. Total	\$ 293,474.29	100. Total	\$ 293,474.29		





2. Notes and accounts receivable:		\$ 29,378.91	\$ 26,292.12	\$ 132,935.11	\$ 132,117.10
Less: Allowance for bad debts:		3,086.79			
<b>3. Inventories:</b>					
(a) Raw materials:					
(b) Work in process:					
(c) Finished goods:					
(d) Supplies:					
<b>4. Investments in governmental entities:</b>					
(a) Federal bonds:					
(b) State bonds:					
(c) Municipal bonds:					
(d) Other securities:					
(e) Other investments:					
(f) Other assets:					
<b>5. Other investments (itemize):</b>					
<b>6. Capital assets:</b>					
(a) Depreciable assets (itemize):					
(b) Land:					
(c) Other assets (itemize):					
<b>7. Other assets (itemize):</b>					
<b>8. Total Assets:</b>					
<b>9. Liabilities:</b>					
(a) Accounts payable:					
(b) Bonds, notes, and mortgages payable:					
(c) With original maturity of 1 year or more:					
(d) Other liabilities (itemize):					
<b>10. Total Liabilities:</b>					
<b>11. Net Assets:</b>					
(a) Capital stock:					
(b) Preferred stock:					
(c) Common stock:					
(d) Paid-in or capital surplus:					
(e) Earned surplus and undivided profits:					
<b>12. Total Liabilities:</b>					
<b>Schedule M—RECONCILIATION OF NET INCOME AND ANALYSIS OF EARNED SURPLUS AND UNDIVIDED PROFITS</b>					
1. Total distributions to stockholders (change to earned surplus during the taxable year):					
(a) Cash:					
(b) Stock of the corporation:					
(c) Contributions or gifts (excess over 5 percent limitation):					
(d) Federal income tax excess profit tax (United States provision if claimed as a credit in the taxable year):					
(e) Federal taxes paid on tax-free government bonds:					
(f) Special improvement taxes (adding to increase the value of the property assessed):					
(g) Repurchases, forwards, and capital expenditures:					
(h) Insurance premiums paid on the life of an officer or director (including a beneficiary):					
(i) Unearned surplus (unearned income):					
(j) Excess of capital losses over capital gain:					
(k) Additions to surplus reserves (less withdrawals):					
(l) Other:					
(m) Total:					
2. Other unfavorable deductions:					
(a) State tax add:					
(b) Other:					
3. Adjustments for tax purposes not reported on books (itemize):					
(a) Deprec. Adj.:					
(b) Other:					
4. Surplus debits to earned surplus (itemize):					
(a) Other:					
5. Earned surplus and undivided profits as shown on books (itemize):					
(a) Total:					
10. Total of lines 1 to 15:					

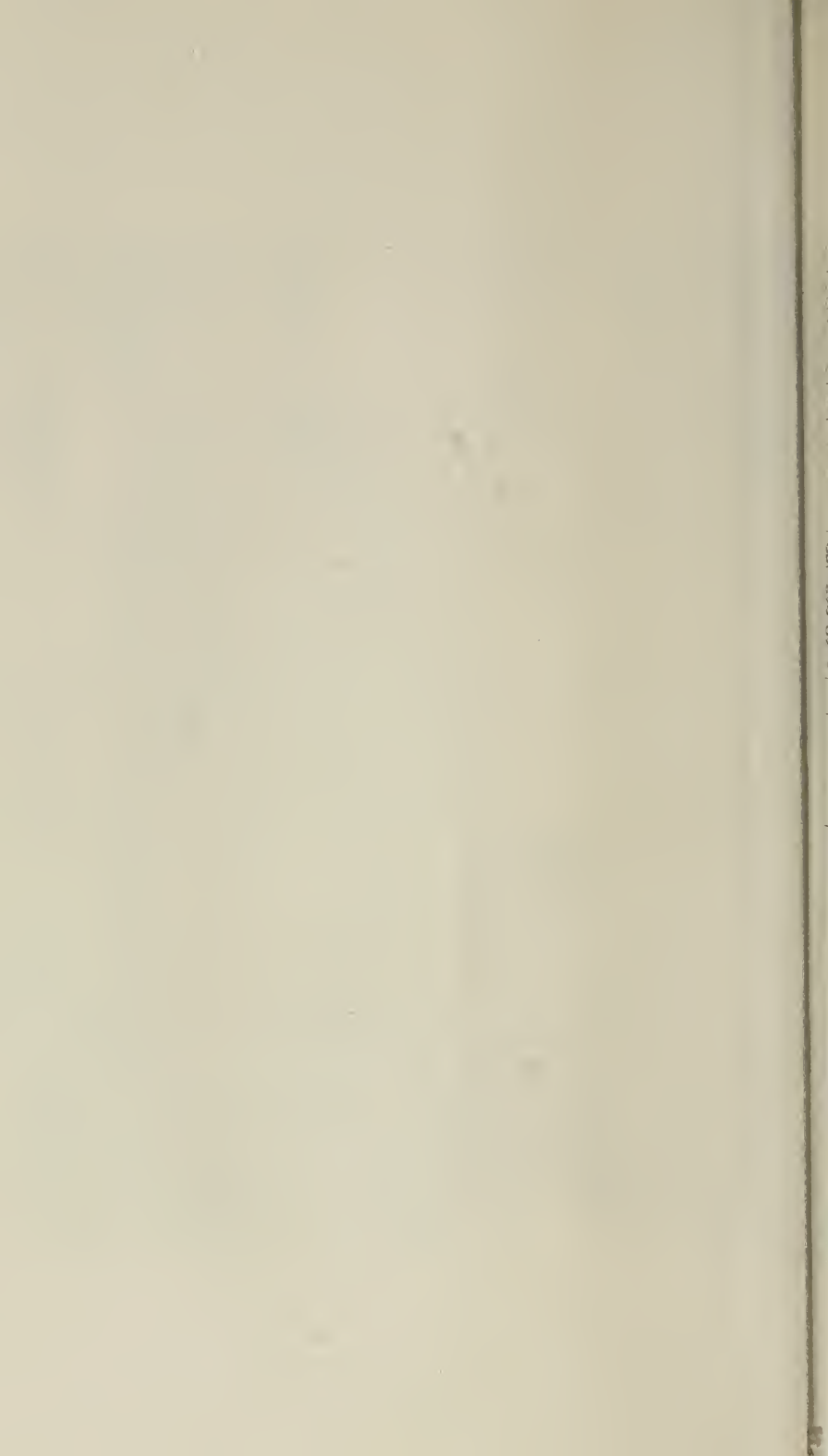




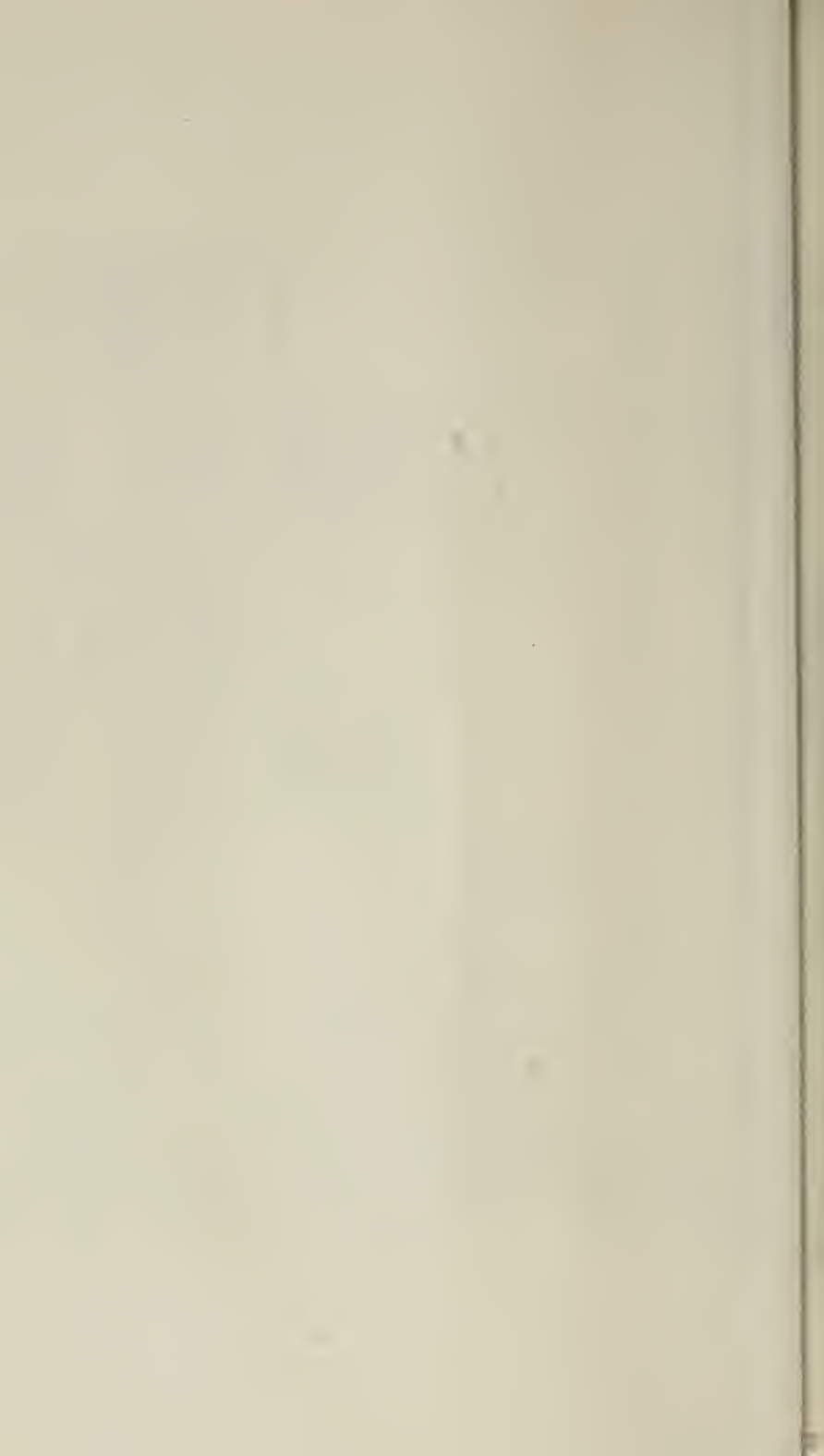


Assets	Total	Assets	Total	Assets	Total
1. Cash	\$ 10,747.85				
2. Notes and accounts receivable	\$ 13,559.57				
3. Income tax receivable for last year	\$ 2,222.29				
4. Total	\$ 26,539.71				
5. Inventory	\$ 177,655.70				
6. Capital assets					
(a) Depreciable assets (see instructions)	\$ 16,977.20				
(b) Land	\$ 11,588.77				
(c) Buildings, machinery, and equipment	\$ 11,097.61				
(d) Furniture and fixtures	\$ 5,412.11				
(e) Total depreciable assets	\$ 44,075.69				
(f) Land	\$ 11,588.77				
(g) Total capital assets	\$ 55,664.46				
7. Other assets (see instructions)	\$ 18,111.90				
8. Total assets	\$ 100,316.07				
9. Liabilities					
(a) Accounts payable	\$ 10,227.79				
(b) Notes, mortgages, and other debts payable	\$ 7,764.19				
(c) Total liabilities	\$ 18,000.00				
10. Total liabilities and equity	\$ 18,000.00				
11. Total equity	\$ 82,316.07				
12. Total equity and liabilities	\$ 100,316.07				
13. Total equity and liabilities	\$ 100,316.07				
14. Total equity and liabilities	\$ 100,316.07				
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95. Total equity and liabilities	\$ 100,316.07				
96. Total equity and liabilities	\$ 100,316.07				
97. Total equity and liabilities	\$ 100,316.07				
98. Total equity and liabilities	\$ 100,316.07				
99. Total equity and liabilities	\$ 100,316.07				
100. Total equity and liabilities	\$ 100,316.07				





1. Cash	\$ 135,559 57	\$ 10,649 86	\$ 221,374 30	\$ 75,443 74
2. Notes and accounts receivable	2,222 29	133,337 28	932 24	226,442 06
3. Inventories:				
(a) Raw materials				
(b) Work in process				
(c) Finished goods		177,655 70		286,567 42
4. Investments in governmental obligations:				
(a) United States bonds, and Federal land bank stock, and Federal Intermediate Finance Corporation bonds, Treasury bonds, and United States savings bonds, issued prior to December 1, 1940, and United States savings bonds, issued prior to March 1, 1941				
(b) Obligations of the United States				
(c) Obligations of Federal land banks, joint stock land banks, and Federal Intermediate Finance Corporation, issued prior to March 1, 1941				
(d) Other non-taxable income (itemize)				
5. Other investments (itemize)				
6. Capital assets: Machine & Shop Equip:	16,727 20		19,703 77	
(a) Depreciable assets (itemize) Fert's & Access. Equip:	11,858 77		12,355 77	
(b) Furniture and fixtures	11,097 81		12,905 23	
(c) Service cars	11,158 11		14,229 80	
(d) Total depreciable assets	39,083 82		46,990 80	
(e) Dupl. assets	26,221 49	25,250 62	24,026 29	35,221 63
(f) Less: Reserve for depletion				
7. Other assets (itemize): Prepaid Ins., Taxes, Etc.	4,841 20		5,641 52	
8. Total Assets	4,841 20	4,841 20	5,641 52	
9. Accounts payable		381,734 66	599,316 37	
10. Bonds, notes, and mortgages payable:				
(a) With original maturity of less than 1 year		80,043 68	79,622 59	
(b) With original maturity of 1 year or more				
11. Accrued expenses (itemize): Taxes	40,237 79	40,237 79	6,422 94	
12. Other liabilities (itemize)	34,292 56	101,154 18	75,085 70	187,414 62
13. Surplus reserves (itemize)				
14. Capital stock:				
(a) Preferred stock				
(b) Common stock	85,000 00	85,000 00	85,000 00	85,000 00
15. Paid-in or capital surplus		75,299 01	240,896 62	
16. Earned surplus and undivided profits				
17. Total Liabilities		381,734 66	599,316 37	
<b>Schedule M—RECONCILIATION OF NET INCOME AND ANALYSIS OF EARNED SURPLUS AND UNDIVIDED PROFITS</b>				
1. Total distributions to stockholders charged to earned surplus during the taxable year:				
(a) Stock of the corporation				
(b) Other property				
2. Contributions or gifts (excess over 5 percent)				
3. Federal income and excess profits taxes				
4. Income taxes of foreign countries or United States citizens or residents (itemize):				
(a) Income taxes of foreign countries or United States citizens or residents (itemize):				
(b) Federal taxes paid on tax-free covenant bonds				
5. Special improvement taxes tending to increase value of property				
6. Special improvement taxes tending to increase value of property				
7. Employees' reserves and capital expenditures charged to expenses in the books of the corporation				
8. Interest on bonds, notes, and mortgages of other or employees when the corporation is directly or indirectly a beneficiary				
9. Unpaid interest on bonds, notes, or mortgages				
10. Excess of capital losses over capital gains				
11. Additions to surplus reserves (list separately):				
(a)				
(b)				
(c)				
12. Other unallowable deductions:				
(a)				
(b)				
13. Adjustments for tax purposes not recorded in books (itemize)				
(a)				
(b)				
14. Surplus credits to earned surplus (itemize):				
(a)				
(b)				
15. Earned surplus and undivided profits as shown in books (itemize) (Schedule L)				
16. Total of lines 1 to 15				



ASSETS		Liabilities and Equity, 1948		Total	
1. Cash	\$ 227,374 30	\$ 75,443 74	\$ 227,374 30	\$ 75,443 74	\$ 97,423 07
2. Notes and accounts receivable	932 24	226,442 06	932 24	226,442 06	242,357 67
3. Inventories:					
(a) Raw materials					
(b) Finished goods					
(c) Supplies					
4. Investments in governmental obligations					
(a) Federal bonds					
(b) State bonds					
(c) Municipal bonds					
(d) Corporate bonds					
(e) Other investments					
5. Other investments (financial)					
(a) Real estate					
(b) Other investments					
6. Other investments (financial)					
(a) Real estate					
(b) Other investments					
7. Other assets (financial)					
(a) Land					
(b) Buildings					
(c) Equipment					
(d) Other assets					
8. Total Assets					
9. Accounts payable					
10. Bonds, notes, and mortgages payable					
(a) With original maturity of less than 1 year					
(b) With original maturity of 1 year or more					
11. Accrued expenses (financial)					
(a) Salaries and wages					
(b) Other accrued expenses					
12. Other liabilities (financial)					
13. Surplus reserves (financial)					
14. Capital stock:					
(a) Preferred stock					
(b) Common stock					
15. Retained earnings					
16. Excess surplus and undivided profits					
17. Total Liabilities					
Schedule M—RECONCILIATION OF NET INCOME AND ANALYSIS OF EARNED SURPLUS AND UNDIVIDED PROFITS					
1. Total distribution to stockholders charged to earnings and retained earnings					
(a) Cash					
(b) Stock of the corporation					
(c) Other property					
2. Contributions or gifts (excess over 5 percent)					
3. Federal income and excess profits taxes					
4. Income taxes of foreign countries or United States					
5. Federal taxes paid on tax-free government bonds					
6. Federal income taxes on dividends or interest					
7. Repurchases of new shares and capital expenditures charged to expense on liquidation					
8. Excess of liquidation proceeds over the book value of the corporation					
9. Excess of liquidation proceeds over the book value of the corporation					
10. Excess of liquidation proceeds over the book value of the corporation					
11. Additions to surplus reserves (not separately stated)					
12. Other unallowable deductions:					
(a) Excess of liquidation proceeds over the book value of the corporation					
(b) Excess of liquidation proceeds over the book value of the corporation					
(c) Excess of liquidation proceeds over the book value of the corporation					
(d) Excess of liquidation proceeds over the book value of the corporation					
13. Adjustments for tax purposes not recorded on books					
(a) Excess of liquidation proceeds over the book value of the corporation					
(b) Excess of liquidation proceeds over the book value of the corporation					
(c) Excess of liquidation proceeds over the book value of the corporation					
(d) Excess of liquidation proceeds over the book value of the corporation					
14. Total of items 1 to 15					
15. Total of items 1 to 15					
16. Total of items 1 to 15					





No. 15386

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In the United States Court of Appeals  
for the Ninth Circuit

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F. NORMAN PHELPS AND ALICE PHELPS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

---

ON PETITION FOR REVIEW OF THE DECISION  
OF THE TAX COURT OF THE UNITED STATES

---

BRIEF FOR THE RESPONDENT

---

CHARLES K. RICE,  
*Assistant Attorney General.*  
ELLIS N. SLACK,  
HARRY BAUM,  
C. GUY TADLOCK,  
  
*Attorneys,*  
*Department of Justice,*  
*Washington 25, D. C.*

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FILED

MAY 13 1957



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The Tax Court properly found that the redemptions of portions of taxpayer's stock in three corporations were made at such time and in such manner as to make the transactions essentially equivalent to the distribution of taxable dividends under Section 115 (g) of the Internal Revenue Code of 1939..... 16

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**In the United States Court of Appeals  
for the Ninth Circuit**

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No. 15386

F. NORMAN PHELPS AND ALICE PHELPS, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

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**ON PETITION FOR REVIEW OF THE DECISION  
OF THE TAX COURT OF THE UNITED STATES**

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**BRIEF FOR THE RESPONDENT**

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**OPINION BELOW**

The opinion of the Tax Court is reported at 26 T.C. 846.

**JURISDICTION**

This petition for review (R. 45-50) involves federal income taxes for the taxable year 1948. On August 19, 1953, the Commissioner of Internal Revenue mailed to the taxpayer a notice of deficiency in the total amount of \$107,926.06. (R. 11.) Within ninety days thereafter and on November 17, 1953, the taxpayer filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code of 1939, as amended. (R. 3.) The decision of the



Tax Court was entered on July 31, 1956. (R. 44.) This case is brought to this Court by a petition for review filed October 25, 1956. (R. 45-50.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

### QUESTION PRESENTED

Did the Tax Court err in finding as a fact that the corporate distributions out of earnings and profits, in redemption of portions of taxpayers' stock in three corporations, were essentially equivalent to distributions of taxable dividends under Section 115 (g) of the Internal Revenue Code of 1939?

### STATUTE AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra*.

### STATEMENT

The facts as stipulated to by the parties (R. 16-25) and as found by the Tax Court (R. 27-41) may be summarized as follows:

On April 10, 1946, the taxpayer,<sup>1</sup> Jackson Howell and James A. Kenyon, who had been operating three Chevrolet dealerships as limited partnerships, incorporated the concerns as the Capitol Chevrolet Company, the Mid-Valley Chevrolet Company and the Howell Chevrolet Company. (R. 28-29.) One-half of the stock in Capitol and Mid-Valley was issued to taxpayer and his wife Alice Phelps, and one-half was

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<sup>1</sup> F. Norman Phelps is hereinafter referred to as the taxpayer, his wife being included as a party merely because joint returns were filed.

issued to Kenyon, represented by the Patricia May Kenyon Trust and the J. A. K. Company, a holding company, all stock of which was owned by Mr. Kenyon.<sup>2</sup> Taxpayer and his wife were issued 33 1/3 per cent of the Howell Company stock as were Jackson Howell and the Kenyon interest. (R. 29.) Stock in the new corporations<sup>3</sup> from the date of incorporation until December 21, 1948, was outstanding as follows (R. 29):

*Capitol Chevrolet Company*

*No. of Shares*

F. Norman Phelps.....	212
Alice Phelps .....	213
James A. Kenyon, Trustee of Patricia May Kenyon Trust .....	170
J. A. K. Company .....	255

*Mid-Valley Chevrolet Company*

F. Norman Phelps .....	213
Alice Phelps .....	212
James A. Kenyon, Trustee of Patricia May Kenyon Trust .....	170
J. A. K. Company .....	255

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<sup>2</sup> The Patricia May Kenyon Trust was created on August 8, 1941, by James A. Kenyon for the benefit of his adopted daughter. Kenyon was not only settlor, but was trustee with power to deal with the trust property as absolute owner thereof including the power of sale. He had no beneficial interest in the income or corpus of the trust other than a remote reversionary interest. (R. 28.) The stockholdings of the trust and the J. A. K. Company will be referred to as the Kenyon interest.

<sup>3</sup> The dealerships were corporations prior to 1944 and operated as partnerships for only about 2 years prior to incorporation in 1946. The financial interest of the various individuals remained in substantially the same ratio throughout these transitions. (R. 24-25.)

*Howell Chevrolet Company*

F. Norman Phelps .....	150
Alice Phelps .....	150
James A. Kenyon, Trustee of Patricia May Kenyon Trust .....	120
J. A. K. Company .....	180
Jackson Howell .....	300

The taxpayer, Kenyon and Howell had similar backgrounds in the automobile business through connections over many years with the Chevrolet Division of General Motors Corporation or General Motors Acceptance Corporation. They served in various capacities such as, salesmen, used car managers, city, district, zone and regional managers, etc. (R. 30.)

The three corporations engaged in the business of operating Chevrolet dealerships under a selling agreement with General Motors which was in force for a period of one year, renewable on November 1st of each year. This agreement, which constituted the only understanding between the parties, provided for its termination by either party upon written notice, in the event either party violated or failed to comply with any of its provisions. It also provided that persons actually participating in the ownership and responsibility of a dealership must be named in the agreement. Implementing this latter provision was a policy of Chevrolet that those so named must own at least 25 percent of the stock. (R. 30-32.)

In September of 1948, J. L. Connell, the regional manager for Chevrolet, called the taxpayer to his office and advised him of a new policy adopted by General Motors under which no trust or holding company could hold stock in a Chevrolet dealership, and

that the stock ownership of the Kenyon Trust and the J. A. K. Company must be eliminated. The taxpayer, because of his long association with Chevrolet, knew that such advice concerning a change in policy must be followed and he assured Connell that the three dealerships would comply. Connell also suggested to the taxpayer that, because of the satisfactory operation of the dealerships under Howell, Kenyon and the taxpayer, it would be more than fair, after meeting the new policy, for the three of them to maintain the same percentage of ownership in the companies. Connell was not stating Chevrolet policy in making this latter suggestion and did not intend an implied threat that no new selling agreement would be issued if the ratio of ownership was not maintained. (R. 31-32.)<sup>4</sup>

On November 1, 1948, the three corporations received their new selling agreements together with two letters each covering the new policy. One to each company was a notification of unsatisfactory operations because all or a part of the ownership was held by a trust and the other, that their operations were unsatisfactory because all or part of the ownership was held by a holding company. Each letter stated that "it is the desire and policy of Chevrolet Motor Division that all ownership of the Chevrolet dealership be held directly by individuals approved by Chevrolet Motor Division" and that the new Chevrolet

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<sup>4</sup> The taxpayer had previously been advised by Chevrolet's Zone managers, Mr. Clarence DeLang and Mr. A. Strang, of the change in policy requiring the elimination of the trust and the holding company. (R. 154, 155, 165, 166.)

selling agreement was being delivered "upon the express representation by you that action will be taken to effect the foregoing objective not later than" a specified date. The date specified for elimination of ownership of stock by the trust was April 30, 1949, and by the holding company September 30, 1949. The probable consequence of failure to take the action required to satisfy the stock ownership policy would be that each corporation would receive a letter from Chevrolet stating that a new selling agreement would not be offered upon the expiration of the November 1, 1948, agreement because of non-compliance with its policy. (R. 34-35.)

Sometime after his meeting with Connell on September 1, 1948, and before the receipt of the new agreements and the letters on November 1, 1948, the taxpayer contacted Kenyon and advised him of his conversation with Connell. Taxpayer suggested to Kenyon that he confer with Thomas E. Dempsey, attorney for the owners and for the three corporations, and have him work out some plan to meet the requirements of Chevrolet. Kenyon discussed the matter with Dempsey. In the course of their discussions the possibility of Kenyon personally purchasing all of the stock of the three corporations owned by the trust was considered. This possibility was deemed not feasible because Kenyon did not have the money to make the purchase. Kenyon did not want the stock held by the trust sold to someone other than himself because he was desirous of maintaining his relative proportional voting interest and control in the dealerships. Kenyon and Dempsey also consid-



ered the possibility of eliminating the J. A. K. Company ownership of stock by means of a liquidation. Dempsey recommended that this not be done during the year 1948 because it would cost about \$90,000 in taxes whereas if it were postponed until the Revenue Act of 1949 were passed the liquidation might be accomplished tax free. (R. 32-33.)

After being advised of the attorney's recommendation against the liquidation of J. A. K. Company in 1948, taxpayer wrote the zone manager of Chevrolet at Oakland, California, on October 16, 1948, stating, among other things, the following (R. 33-34):

As you know, the J. A. K. Co., which is a Nevada corporation owned by James A. Kenyon, now owns 30 percent of the stock in Capitol Chevrolet Company, 30 percent in Mid-Valley Chevrolet, and 20 percent in Howell Chevrolet. Our attorney advises that if this J. A. K. Co. were to be liquidated at the present time, the tax situation is such that Mr. Kenyon and I would be subject to approximately \$90,000 in tax.

It would seem that if it were possible for you to permit us to postpone the change until the Revenue Act of 1949 passes both the House and the Senate it would be most helpful to us.

\* \* \* \*

At the present time we are working on a way to buy out the Trust by the different corporations. We believe this can be handled because although it is an irrevocable Trust, Mr. Kenyon has jurisdiction over the Trust until his daughter becomes of age.

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Because of the complications, I would appreciate Chevrolet Motor Division giving us six months or a year to work out of the seeming difficulties with which we are faced at the present time.

In addition to writing the foregoing letter the taxpayer also discussed the matter with Connell, the regional manager, and asked him whether or not it would be satisfactory if the liquidation of J. A. K. Company were delayed until the new law was passed, and it was agreed by Connell that some extension would be given. (R. 34.)

Pursuant to a prior agreement between Kenyon and the taxpayer, any tax liability which would result from the liquidation of J. A. K. Company was to be shared between them. This company was not liquidated in 1948 because of the income tax liabilities that would result from such liquidation and the possibility that they would be reduced by new tax legislation in 1949. (R. 34.)

Dempsey formulated a plan for eliminating the trust as stockholder of each corporation and it was presented at meetings of their boards of directors held in his office on December 21, 1948, and approved. The plan had two separate steps (R. 35-36):

- (1) The purchase by each of the three corporations of a certain number of shares in such corporation from the trust, as well as the purchase by each of these corporations of a sufficient number of shares from the other stockholders (except J. A. K. Co.) so that the Phelps-Kenyon control in Capitol Chevrolet Co. and Mid-Valley Chevrolet Co. would remain at 50

percent each and the Phelps-Kenyon-Howell control in Howell Chevrolet Co. would remain at 33 1/3 percent each; and

(2) The purchase by James A. Kenyon, personally, of the remaining shares owned by the Trust in each of the three corporations which were not to be purchased in Step (1).

The second step in the plan was expressly conditioned on the ability of Kenyon to secure the authorization of the Superior Court of the State of California of his purchase of the stock from the trust; and, as an alternative to be used in the event the court should fail to authorize such purchase, the plan provided that the three corporations would, respectively, purchase the remaining shares owned by the trust and that Kenyon would purchase the same number of shares from the other stockholders of each corporation, in such manner as to preserve the same percentage of control. (R. 36.)

At the meetings held on December 21, 1948, the directors of each corporation adopted the following resolution (R. 36-37):

Whereas the purchase and redemption of stock according to the plan hereinabove set forth will reduce the corporation's working capital below its minimum requirements;

Now, Therefore, Be It Resolved that the officers of this corporation be and they hereby are authorized and directed to borrow, in behalf of this corporation, from such banks or trust companies as they may in their judgment determine, an amount not exceeding \$200,000, for such period of time and upon such terms and rate of interest as may to them in their discretion seem

advisable and to execute notes in respect thereto in the name of the corporation for the payment of the amount so borrowed.

Step 1 of the plan was executed on December 21, 1948, with the result that on that date the three corporations made distributions to stockholders in redemption of shares of stock, as follows (R. 37):

#### CAPITOL CHEVROLET CO.

<i>Shareholder</i>	<i>Amt. Distributed</i>	<i>Shares Redeemed</i>
F. Norman Phelps .....	\$37,759.15	65
Alice Phelps .....	37,759.15	65
Patricia May Kenyon Trust .....	75,518.30	130

#### MID-VALLEY CHEVROLET CO.

F. Norman Phelps .....	\$37,170.25	65
Alice Phelps .....	37,170.25	65
Patricia May Kenyon Trust .....	74,340.50	130

#### HOWELL CHEVROLET CO.

F. Norman Phelps .....	\$23,254.00	50
Alice Phelps .....	23,254.00	50
Patricia May Kenyon Trust .....	46,508.00	100
Jackson Howell .....	46,508.00	100

Prior to December 21, 1948, Dempsey sent taxpayer copies of proposed minutes of the directors' meetings which he had prepared. Before receiving these minutes taxpayer was aware of the nature of the plan which was to be submitted to the directors, but its details had not theretofore been presented to him in writing. Howell was not present at the December 21, 1948, meeting of the directors of the Howell Chevrolet Company and had no knowledge of

the details of the plan until after it was adopted. Neither taxpayer and his wife nor Howell needed the money distributed to them in redemption of their stock. (R. 37-38.)

The shares of stock redeemed by the corporations were cancelled and the stated capital reduced accordingly. The operations of the corporations were not curtailed as a result of the redemptions, and they did not enter into any program of liquidation. (R. 38.)

The stock ownership in Mid-Valley Chevrolet Company and Capitol Chevrolet Company immediately before and after the redemptions was as follows (R. 38):

	Before—50%	After—50%
F. Norman Phelps	213 shares 25%	148 shares 25%
Alice Phelps	212 shares 25%	147 shares 25%
	Before—50%	After—50%
J. A. Kenyon, Trustee	170 shares 20%	40 shares 7%
J. A. Kenyon Company	255 shares 30%	255 shares 43%

The stock ownership in Howell Chevrolet Company immediately before and after the redemptions was as follows (R. 38):

	Before—33 1/3%	After—33 1/3%
F. Norman Phelps	150 shs. 16 2/3%	100 shs. 16 2/3%
Alice Phelps	150 shs. 16 2/3%	100 shs. 16 2/3%
	Before—33 1/3%	After—33 1/3%
J. A. Kenyon, Trustee	120 shs. 33 1/3%	20 shs. 3 1/3%
J. A. Kenyon Company	180 shs. 20%	180 shs. 30%
	Before—33 1/3%	After—33 1/3%
Jackson Howell	300 shs. 33 1/3%	200 shs. 33 1/3%



In the redemptions, the price paid per share in each of the corporations was as follows (R. 38):

Mid-Valley Chevrolet Co. ....	\$571.85
Capitol Chevrolet Co. ....	580.91
Howell Chevrolet Co. ....	465.08

The total amounts actually distributed by each corporation through the distributions in issue were as follows (R. 39):

Mid-Valley Chevrolet Co. ....	\$148,681.00
Capitol Chevrolet Co. ....	151,036.60
Howell Chevrolet Co. ....	139,524.00

If the corporations had purchased all the shares of the trust without redeeming shares of the other stockholders, only the following amounts would have been required (R. 39):

Mid-Valley Chevrolet Co. ....	\$97,214.50
Capitol Chevrolet Co. ....	98,747.70
Howell Chevrolet Co. ....	55,809.60

If only the shares of the trust had been redeemed by the three corporations, their capital would not have fallen below the capital standard requirements set by Chevrolet. (R. 39.)

Because of the fact that the shares of other stockholders were redeemed along with the trust shares, the capital of the corporations fell below the standards set by Chevrolet. The additional cash distributions to the other stockholders placed a hardship on the corporations by requiring them to borrow funds. Failure to meet the capital standard requirements is reason for termination of a dealer's franchise. (R. 39.)

The 1948 redemptions did not eliminate either the trust or the holding company as stockholders of the three corporations. (R. 39.)

At the time of the 1948 distributions, the accumulated earnings and profits of each of the corporations were in excess of the total amount distributed to the shareholders. Earned surplus and undivided profits of each of the corporations as of December 31, 1948, after the distributions had been made, were as follows (R. 39-40):

Mid-Valley Chevrolet Co. ....	\$275,536.12
Capitol Chevrolet Co. ....	285,666.90
Howell Chevrolet Co. ....	223,970.73

No dividends were ever declared or paid by any of the three corporations. (R. 40.)

The consummation of step 2 of the plan was commenced on June 1, 1949, by the filing by Kenyon, as Trustee of the Patricia May Kenyon Trust, of a petition to the Superior Court of the State of California, in and for the County of Los Angeles, for an order to sell the remaining trust stock in Capitol Chevrolet Company and Howell Chevrolet Company to those corporations, respectively, and by the liquidation of Mid-Valley Chevrolet Company. (R. 40.)

During the year 1950 and prior to July 26, 1950, J. A. K. Company was completely liquidated and all of the stock held by it in each of the three corporations was distributed to Kenyon. (R. 40.)

On July 26, 1950, Capitol Chevrolet Company purchased from Kenyon the 255 shares of its stock then owned by him and also purchased from the trust the 40 shares of its stock owned by the trust. Howell

Chevrolet Company purchased from Kenyon the 180 shares of its stock then owned by him and also purchased from the trust the 20 shares of its stock owned by the trust; and Mid-Valley Chevrolet Company purchased from Phelps the 148 shares of its stock then owned by him, and from Alice Phelps the 147 shares of its stock then owned by her. Thereafter during the year 1950 Mid-Valley Chevrolet Company was completely liquidated and dissolved and all of its assets transferred to its stockholders. (R. 40-41.)

Chevrolet did not object to the changes in the proportionate ownership and control of the three dealerships made during the year 1950. (R. 41.)

Upon these facts the Tax Court found that the distributions to the trust were not essentially equivalent to distributions of taxable dividends for the reason, stated in the court's opinion, that it was the first step in an integrated plan of complete elimination of the trust's ownership in the three companies. (R. 41-42.)

The court found as a fact that the distributions to the other stockholders, including the taxpayers herein, were made at such time and in such manner as to be essentially equivalent to distributions of taxable dividends. (R. 41.) Mr. and Mrs. Phelps have petitioned the Court to review this latter finding. (R. 45-50.)

#### SUMMARY OF ARGUMENT

The Commissioner determined that taxable dividends resulted from the redemptions of portions of taxpayer's stock in three corporations. The Tax Court sustained this determination and found as a

fact that the distributions in redemption of the stock were made at such time and in such manner as to be essentially equivalent to distributions of taxable dividends under Section 115 (g) of the Internal Revenue Code of 1939.

The question of dividend equivalence has been held to be one of fact, and upon review the lower court's findings and decisions have not been disturbed unless they are "clearly erroneous."

This review necessarily requires an examination of the entire record by the appellate court. In making such an examination it will be discovered that there was ample evidence before the Tax Court to justify its ultimate findings, particularly in the light of the decided cases by this Court and other appellate courts.

The taxpayer contends that there was a legitimate business purpose for the redemption. Aside from the fact that the presence or absence of a business purpose is only one of the many "judicial criteria" to be considered in determining the question, the record shows clearly that there was no real corporate business purpose which motivated the redemptions in issue.

It has been held uniformly that no one factor is determinative of the issue and, that in the final analysis, it is the net effect or the reality of the situation which determines whether there has been, in fact, a distribution of a taxable dividend as opposed to a partial liquidation. In arriving at the net effect of the transaction the courts have developed a number of factors to be considered. The Tax Court reviewed each of these factors and found from the

record (1) a substantial accumulation of earnings and profits from which the redemptions were made; (2) no previous dividend declarations by any of the three corporations involved; (3) the absence of a corporate purpose; (4) no contraction or curtailment in business activities; (5) the particular plan of redemption originating with the stockholders; (6) the only benefit from the transactions accruing to the shareholders; and (7) a pro rata distribution of cash in cancellation of stock which resulted in a retention of the same proportion of control and fraction ownership by the same stockholder interests.

The Tax Court exercised its function with care and its findings are supported fully by the record.

### ARGUMENT

**The Tax Court Properly Found That the Redemptions of Portions of Taxpayer's Stock In Three Corporations Were Made At Such Time and In Such Manner As To Make the Transactions Essentially Equivalent To the Distribution of Taxable Dividends Under Section 115(g) of the Internal Revenue Code of 1939**

The sole issue for determination is whether the evidence supports the Tax Court's finding as a fact that the redemptions of portions of taxpayer's stock were essentially equivalent to the distribution of a taxable dividend.<sup>5</sup>

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<sup>5</sup> The distributions in redemption of the stock owned by the Kenyon Trust are not involved in this appeal. The Tax Court, overruling the Commissioner's determination, found that these constituted a step in an integrated plan to eliminate the trust as a stockholder, and consequently were not essentially equivalent to a dividend. (R. 41-42.) The Commissioner has not cross-appealed from that determination.



Section 115 (g) of the Internal Revenue Code of 1939 (Appendix, *infra*), provides that—

If a corporation \* \* \* redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution \* \* \* in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount \* \* \* shall be treated as a taxable dividend.

The applicable Regulations (Treasury Regulations 111, Section 29.115-9 (Appendix, *infra*)) provide that the question of whether the distribution is equivalent to a taxable dividend depends upon the circumstances of each case, and that a redemption of a portion of stock pro rata among the shareholders will generally be considered as a distribution essentially equivalent to a dividend distribution.

The Commissioner determined in the instant case that there was a taxable dividend under the statute and the Regulations and the Tax Court partially sustained that determination. (R. 11, 43.)

The question is one of fact and the lower court's findings, if supported by the evidence, will not be set aside unless they are clearly erroneous and are induced by an erroneous view of the statute and the applicable decisions. This Court recognized this principle in the recent case of *Earle v. Woodlaw*, decided February 28, 1957 (1957 C.C.H., par. 9472). See also this Court's opinion in *Hirsch v. Commissioner*, 124 F. 2d 24; Section 7482(a), Internal Revenue

Code of 1954; and Rule 52 (a) of the Federal Rules of Civil Procedure.<sup>6</sup>

No one factor or fixed formula has been established for determining the question of dividend equivalence. In the *Woodlaw* case, *supra*, this Court quoted with approval the following statement of Judge Vinson in *Flanagan v. Helvering*, 116 F. 2d 937, 939 (C.A. D.C.):

In determining whether a transaction is equivalent to a taxable dividend under § 115 (g), or whether it is a partial liquidation within § 115 (c), neither the Board of Tax Appeals nor the courts have laid down a sole decisive test.

The courts have given consideration to many elements in resolving the question, the principle <sup>at</sup> ones having

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<sup>6</sup> Practically, all of the appellate courts have taken the view that each case of this type must be decided upon its own peculiar set of facts, that the net effect of the transaction is the fundamental question to be decided in administering Section 115 of the 1939 Code, and the determination of the lower court is in the words of the Third Circuit in *Ferro v. Commissioner*, decided March 20, 1957 (1957 C.C.H., par. 9498), "reviewable \* \* \* only to the extent of ascertaining whether substantial evidence exists in the record to support that determination \* \* \*." *Bazley v. Commissioner*, 155 F. 2d 237 (C.A. 3d), affirmed, 331 U.S. 737; *Keefe v. Cote*, 213 F. 2d 651 (C.A. 1st); *Kirschenbaum v. Commissioner*, 155 F. 2d 23 (C.A. 2d), certiorari denied, 329 U.S. 726; *Commissioner v. Roberts*, 203 F. 2d 304 (C.A. 4th); *Commissioner v. Sullivan*, 210 F. 2d 607 (C.A. 5th); *Chandler's Estate v. Commissioner*, 228 F. 2d 909 (C.A. 6th); and *Koepke v. Commissioner*, 230 F. 2d 950 (C.A. 6th); *Commissioner v. Snite*, 177 F. 2d 819 (C.A. 7th); *Randolph v. Commissioner*, 76 F. 2d 472 (C.A. 8th), certiorari denied, 296 U.S. 599; and *Jones v. Griffin*, 216 F. 2d 885 (C.A. 10th).

been stated by this Court in *Woodlaw* substantially as follows: (1) Was there an accumulation of earnings and profits from which the redemption was made; (2) was there a business purpose being carried out by the corporation, as distinguished from a benefit accruing to the stockholders, coupled with a suggestion of the transaction from the stockholders; (3) what has been the dividend policy of the corporation; (4) was there a contraction in the business, i.e., a partial curtailment or liquidation; and (5) did the stockholders retain their relative positions of control, influence and interest in the affairs of the corporation.

In reviewing the record, this Court will discover that the Tax Court's findings were not only free from clear error, but were fully warranted by the evidence.

The taxpayer's principal contentions are that (1) there was a legitimate business purpose for the distribution (Br. 24-29); (2) distributions were not made pro rata (Br. 30); and (3) there was a partial liquidation of the three corporations, and that consequently the payments in redemption should be treated as in part or full payment in exchange for corporate shares as provided for in Section 115 (c) of the 1939 Code (Appendix, *infra*). (R. 214; Br. 41.)<sup>7</sup>

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<sup>7</sup> Taxpayer's opening contention (Br. 19-22) that the Tax Court committed prejudicial error in finding that the distributions in question reduced the corporations' capital below the standards set by Chevrolet is unworthy of serious consideration. Taxpayer acknowledges (Br. 20-21) that the finding is correct as to two of the three corporations involved

Section 115 (Appendix, *infra*), covers distributions by corporations. Section 115 (a) (Appendix, *infra*), states as a general rule that any distribution to stockholders from earnings and profits is income and taxed as a dividend. Section 115 (c) provides an exception to Section 115 (a) if the distributions are in complete or partial liquidation of the corporation. However, the scope of Section 115 (c) is limited by the provisions of Section 115 (g) which states in effect that if stock is cancelled or redeemed at such time and in such manner as to make the distribution in whole or in part essentially equivalent to a dividend then such distribution shall be taxed as a dividend.

Because of the words "essentially equivalent", Treasury Regulations 111, Section 29.115-9, provide and the courts have held that the question is one of fact to be decided after the consideration of a number of relevant criteria. This application of certain "judicial criteria" to the particular set of facts is necessary to determine the net effect or reality of the transaction under consideration. It is clear from a review of the facts in the case that the net effect of the transaction was to drain off large accumulations of earnings and at the same time leave the continuing stockholders in exactly the same position of

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and, as pointed out below, it is also correct as to the third corporation. At any rate, as is plain from the Tax Court's opinion, read as a whole, this feature was not deemed conclusive, as taxpayer apparently assumes, but was merely one of many relevant factors considered by the Tax Court in reaching its decision.



ownership, control and influence as they had before the redemptions. Indeed, the retention of the same ratio of ownership is admitted by the taxpayer to be the principal reason for the particular transactions and the supplemental agreement entered into by the shareholders. (R. 157, 158, 197; Br. 33-34.)

A prerequisite to the application of Section 115 (g) is an accumulation of earnings and profits from which the distributions are made in the redemption of stock. There is no contention that there was a lack of sufficient earnings available in each of the three corporations from which the redemptions herein involved were made. Aside from the fact that the presence of sufficient earnings was stipulated (R. 21) and admitted by taxpayer on brief (p. 32), the record shows that after the distributions, the earned surplus and undivided profits accounts of each corporation exceeded \$200,000 (R. 39-40). The testimony is that the corporations were making "quite a lot of money \* \* \*." (R. 88.) Instead of distributing the very substantial earnings to the stockholders in the form of dividends, they were allowed to accumulate. (R. 21, 40; Br. 30.) While there is no implied criticism of the directors in not declaring dividends during former years, this lack of dividend record is strong evidence that the later distributions took the place of proper and justifiable dividends. This and other appellate courts have recognized as important factors, in determining the question of dividend equivalence, the past record in respect to the payment of dividends, and whether, both before and after the distributions, the corporations had substantial accumulated earn-



ings in excess of the amounts disbursed. *Earle v. Woodlaw*, *supra*; *Boyle v. Commissioner*, 187 F. 2d 557 (C.A. 3d), certiorari denied, 342 U.S. 817; *Flanagan v. Helvering*, *supra*; *Jones v. Griffin*, 216 F. 2d 885 (C.A. 10th); *Commissioner v. Snite*, 177 F. 2d 819 (C.A. 7th); *Kirschenbaum v. Commissioner*, 155 F. 2d 23 (C.A. 2d), certiorari denied, 329 U.S. 726.

The lower court found that there was no contraction or curtailment in the operations of the three dealerships and that there was no plan of liquidation. (R. 38.) The taxpayer and Mr. Howell testified that the businesses continued as before, and there was no curtailment after the distributions (R. 90, 211-212); and on brief, the taxpayer states (p. 24)—

not only did the corporations not adopt any plan for the contraction of their businesses, but also there was no intent to contract \* \* \*.

\* \* \* \*

ultimate dissolution or ultimate contracted operations were never contemplated.

In arriving at the net effect of the transaction support for finding a taxable dividend has been found in the lack of a manifestation of a policy of contraction or liquidation which would necessarily require a diminution in the capital structure. The evidence here shows a continuation of full and successful operations participated in by the taxpayer and the other stockholders to the same extent as before the redemption of a portion of the stock. (R. 90, 211-212.)

The taxpayer contends that the redemptions were made necessary by a demand from Chevrolet that the

trust be eliminated and from a suggestion by Mr. Connell, Chevrolet's regional manager, that the same ratios of control be maintained in the three corporations. (Br. 24-29.) These contentions form the basis for the argument that the sole purpose of the distributions was a legitimate corporate purpose and that the suggestion therefore came from the corporations. (Br. 24.) The Tax Court refutes this contention effectively by stating in its opinion (R. 42-43):

In substance the distributions simply transferred to these stockholders accumulated earnings and profits of their corporations. It is no answer to say that these transactions had their origin in the demand of Chevrolet that the trust be eliminated as a stockholder. That objective could have been achieved, and indeed with less strain upon the corporations, merely by redeeming the shares of the trust. However, Kenyon did not wish to have his control diluted, and Connell, the regional manager for Chevrolet, had himself suggested to Phelps that it would be fair to preserve the same ratios of control. But that suggestion did not represent Chevrolet policy, and we do not believe, on the evidence, that Phelps regarded it as such.<sup>1</sup> It was an objective that the parties themselves would undoubtedly have desired to attain, wholly apart from any suggestion emanating from Connell. Certainly,

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<sup>1</sup> In reaching this conclusion we do not rely upon the testimony given by Connell in his deposition, objected to by petitioners, that Phelps understood the suggestion as being his [Connell's] "rather than General Motor's suggestion or policy".

petitioners, who have the burden of proof, have not shown otherwise.

The lower court had much evidence in the record to support such a statement. There is no dispute as to the dominant motive behind the moves of the taxpayer, Mr. Kenyon and their attorney in devising a plan of redemption. In considering and rejecting plans they were thinking not merely of a way of eliminating the trust, but at the same time of attaining the proportionate control of Messrs. Kenyon and Howell and the taxpayer in the three corporations.<sup>8</sup> (R. 32, 35-36, 69-70.) Kenyon and his attorney, who was also attorney for the taxpayer, Howell and the three corporations, discussed the possibility of Kenyon purchasing all of the stock held by the trust; but, this plan was not feasible because Kenyon did not have the necessary funds. (R. 32, 181.) Before Chevrolet granted an extension of time in which to eliminate the holding company, consideration was given to its liquidation and the transfer of its stock in the dealership to Kenyon. This step was abandoned because of the possible tax consequences of such a move in 1948. (R. 155-156.) Evidently, from a reading of taxpayer's brief (Br. 34-40; Supp. R. 1-21),<sup>9</sup> many alternatives were considered and re-

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<sup>8</sup> In his testimony Mr. Kenyon answers questions concerning the requirements of the letters to the corporations from Chevrolet. These letters required only that the trust and holding company be eliminated; however, the plans discussed were directed at maintaining Kenyon's percentage of ownership and control. (R. 181-182.)

<sup>9</sup> Supp. R. references are to the portions of the record printed in the appendix to taxpayer's brief.

jected, not because they were beneficial or harmful to the corporations, but, rather because they were financially undesirable from the point of view of Kenyon and the taxpayer.

The first notice of Chevrolet's change in policy concerning the ownership of stock in dealerships by trust and holding companies did not come from Mr. Connell. (R. 154, 165-166.) Mr. Clarence DeLong or Mr. A. W. Strang, or possibly both, discussed the matter with the taxpayer and there is no indication that they spoke of the desirability of maintaining the proportionate stock ownership. (R. 165-166.) Subsequent to this discussion Mr. Connell discussed the situation with taxpayer and after advising him of the change in policy, suggested that it might be desirable to continue the Kenyon-Howell-Phelps control of the dealerships. (R. 166.)<sup>10</sup> Shortly after the discussion with Connell, in September of 1948, the taxpayer wrote to two zone managers and advised them that steps were being taken to eliminate the trust and the holding company. (R. 153-154.) And, in a letter to Mr. Strang in October, the taxpayer

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<sup>10</sup> Mr. Connell says that he was not quoting Chevrolet policy when he suggested the retention of control, but, rather he was making only a personal suggestion. (R. 171-172.) His other observations of this discussion with the taxpayer are (1) Chevrolet was not concerned with how the new policy was carried out (R. 166); (2) he did not advise the taxpayer on the subject, but rather only discussed it (R. 165); (3) there was no implied threat that a new selling agreement would not be issued unless the control continued (R. 173); he did not order a retention of the percentage control (R. 176); and he did not believe that the taxpayer understood his suggestion to be General Motor's policy. (R. 172).



asked for an extension of time in which to eliminate the holding company and advised him that plans were being worked out to eliminate the trust from stock ownership. (R. 155-156.) No mention was made in any of this correspondence of the suggestion to retain control proportionately in the remaining stockholders. Then, on November 1, 1948, letters were received from zone managers by the three corporations forwarding new selling agreements and stating that the arrangements were unsatisfactory because portions of the stock in the dealerships were owned by the trust and holding company. (R. 143-153.)<sup>11</sup> The taxpayer, who had extensive experience with General Motors in various capacities, must have known that the selling agreements were the only agreements between the parties and that the letters forwarding them expressed the only official position of Chevrolet. (R. 132-133.) In his statement of facts taxpayer acknowledges that the letters were sent by Chevrolet in "conformance with its new policy \* \* \*." (Br. 11.) The agreements with Chevrolet in effect in the years involved here were personal agreements with the taxpayer (R. 112, 168-169, 171) and could not be modified except in writing approved by both parties (R. 133). Thus, almost two months before the meeting of the board of directors, which was held on December 21, 1948 (R. 36), the tax-

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<sup>11</sup> In placing the letters into evidence taxpayer's counsel offered them merely to show the reason for the action taken, i.e., the elimination of the trust. They could not be used otherwise because no mention of proportionate control is contained in them. (R. 60-64.)



payer knew that the only requirement of Chevrolet was the elimination of the trust and the holding company and that an extension until the following year had been granted with regard to the holding company. He knew at that time, if indeed, he did not know already, that there was no requirement that the ratio of control be maintained.<sup>12</sup> (R. 92-93.) And, at this point the taxpayer also knew of the details of the plan devised by Kenyon and their attorney. (R. 37, 71.)

It is clear from these facts, as well as others found in the record,<sup>13</sup> that the suggestion for the redemp-

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<sup>12</sup> In his deposition, the taxpayer indicated that he considered the change in policy to cover only the trust and the holding company when he said (R. 66):

I informed Mr. Connell that I had been with Chevrolet long enough to know that if they requested that we take the holding company and the Trust out \* \* \* that they meant it, and we would do so immediately.

Then, in discussing the financial situation, he stated that the only reason the companies were below the minimum working capital standards (R. 104-105)—

was because this emergency came up when they insisted they get the Trust and the holding company out of the corporation.

<sup>13</sup> In his statement to the court below taxpayer's counsel explained that the plan suggested by Kenyon and the attorney was designed "to make the takeout in such a manner that after it was completed, Mr. Kenyon and Mr. Phelps would equally control the capital \* \* \*." (R. 197.) In reality because the prime consideration was the welfare of the shareholder's interest, the trust was not eliminated completely in 1948, and no effort was made to eliminate the holding company. (R. 39.) As the Tax Court pointed out, the trust could have been eliminated with a much lower expenditure of funds (R. 42-43), and the holding company could have been liquidated even though by doing so there would

tions came from the taxpayer, Kenyon and their attorney; and, that the particular plan adopted was for the benefit of the share holders, no legitimate corporate purpose being served. Rather than benefiting the corporations, the large disbursements of cash to all of the shareholders reduced "the corporation's working capital below its minimum requirements" and necessitated the passing of resolutions authorizing the directors to borrow \$200,000 for each dealership. (Supp. R. 35, 41, 42, 48.) The taxpayer contends that the Tax Court erred in finding that the redemptions caused the capital of the dealerships to fall below the standards set by Chevrolet. (Br. 19.) Taking his view of the record, the taxpayer admits that the finding was correct with regard to two of the three corporations (Br. 20-21), and that the corporations continued "to grow notwithstanding the temporary setback occasioned by the reductions in their capital resulting from the distributions which were made" (Br. 24). It is submitted that the court below had ample evidence in the record to support such a finding. In addition to the resolutions authorizing the borrowing of \$600,000 to correct the situation, there is an indication that such borrowings were carried out. Mr. Howell testi-

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have been some tax liability attached to such a move. If the large earned surplus had been distributed as dividends before any redemption of stock, the holding company would have been in a position to purchase the trust shares, and the trust would also have received some benefit from the ownership of stock. In reality it never participated in the profits from the operation of the dealerships.

fied that the manner of withdrawing money to eliminate the trust (R. 209)—

placed a hardship on the operation of Howell Chevrolet \* \* \* [and] it was necessary for Howell Chevrolet to borrow money on inventories which had not been the case prior to the taking out of the trust, and the holding company.

Howell also was of the opinion that they would have been “much better off had those funds remained in the business.” (R. 212.) The taxpayer did not recall, but thought that it was necessary to borrow money (R. 91), particularly for Capitol Chevrolet (R. 108-109). As a result of the redemptions it was necessary for the dealerships to “be very frugal” and to take other measures which would raise the capital standards to those required by Chevrolet. (R. 104-105.)<sup>14</sup> Under the facts as revealed in the record it cannot be maintained that the method used to eliminate the trust was beneficial to the corporation or was done to accomplish a corporate purpose. In reality, the benefactors of the plan were Kenyon, who retained his ownership and voting position, and the shareholders, including taxpayer, who received substantial sums of money in redemption of a portion of their stock, while remaining in exactly the same relative position of ownership, control and interest in the affairs of the three corporations. To

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<sup>14</sup> The Capital Standard Agreement between the dealerships and Chevrolet provides that failure to meet the minimum requirements constitutes a ground for the termination thereof. (R. 139.) This is the basis for the Tax Court's finding (R. 39), objected to by taxpayer (Br. 19).

contend that the maintenance of the Kenyon-Howell-Phelps control of the dealerships was for the benefit of the corporations is to overlook the facts previously discussed and considered by the court below and to ignore subsequent events which took place less than two years later (in July of 1950) when the proportionate ownership was changed completely, apparently with the approval of Chevrolet. (R. 41.) Also at about that time the holding company was liquidated and its assets turned over to Kenyon and the trust was eliminated completely from ownership in the dealership. (R. 40.)

The presence or absence of a business purpose for the redemption is one of the factors considered by the courts in a determination of dividend equivalence. At most, however, it has been characterized as only one of the elements and has never been controlling. This Court stated the general rule in *Earle v. Woodlaw, supra*, when it said that the purpose to be considered along with other factors must be corporate as distinguished from a benefit accruing to the shareholders. A mere change in capital structure has been held not to be a legitimate business reason for distributions under Section 115. *Bazley v. Commissioner, supra*. In *Smith v. United States*, 130 F. Supp. 586 (C. Cls.), the court said (p. 591):

It has been recognized by the courts that a legitimate business purpose, separate from tax savings, is an important although not conclusive factor to consider in determining the applicability of section 115 (g). *Keefe v. Cote*, 5 Cir., 213 F. 2d 651; *Commissioner of Internal Rev-*



*enue v. Sullivan, supra; Commissioner of Internal Revenue v. Snite*, 7 Cir., 177 F. 2d 819; *Smith v. United States*, 3 Cir., 121 F. 2d 692, and the cases there cited.

In contending that the distributions were not made pro rata the taxpayer runs squarely into his theory of the case. (Br. 22.) The principal objective was to maintain Kenyon percentage control of the three corporations and this was one of the two results "which was accomplished by the distributions which were actually made." (Br. 33.) Throughout the record and in his brief taxpayer refers to the Kenyon-Phelps control of Capitol Chevrolet and Mid-Valley Chevrolet and of the Kenyon-Phelps-Howell control of Howell Chevrolet. (R. 8, 46, 58, 158; Br. 6, 10, 34; Supp. R. 31-32.) The plan finally adopted was aimed at maintaining the existing voting interest and required a supplemental agreement between the shareholders to preserve the same percentage of control in the event of the failure of Kenyon to obtain state court consent for his purchase of the shares of the trust. (R. 157-159; Supp. R. 31-48.) There is no dispute as to Kenyon's control of the trust. By its terms, he had the power to deal with the property as absolute owner thereof including the power of sale. (Supp. R. 25-27.) In his letter to Strang dated October 16, 1948, the taxpayer assures him of this complete control (Br. 9-10) and in his testimony states that it was not necessary for Kenyon to consult with anyone before voting the stock owned by the trust (R. 105).

It is not contended, and indeed, there could be



no contention, that there was any change in Kenyon's position in the dealerships. After the distributions he remained in control of 50 percent of the stock in Capitol and Mid-Valley and in one-third of the stock in Howell Chevrolet. He continued as a member of the board of directors of the three corporations and remained as one of three principal officers. His interest in the affairs of the corporations continued unabated and his position of influence and participation in the operations was not diminished in any manner. Likewise, the taxpayer and the other stockholders maintained their same percentage of ownership of stock in the dealerships and taxpayer and Howell continued their memberships on the board of directors and as principal officers of the corporation. (R. 19, 38.) In the words of the Tax Court the "stockholders in question emerged with the identical fractional interests in the corporation \* \* \*." (R. 42.)<sup>15</sup>

The final contention of the taxpayer, namely, that the redemptions "constituted partial liquidations of those corporations" is submitted without argument or authority. (Br. 41-42.) It is effectively answered in his own words on brief when he says (p. 24):

Furthermore, not only did the corporations not adopt any plan for the contraction of their busi-

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<sup>15</sup> Chevrolet recognized this equality of control and interest and held Kenyon and taxpayer personally liable under the selling agreements. (R. 168-169.) Kenyon and the taxpayer were the only individuals named in the agreements with Capitol and Mid-Valley; and the taxpayer, Kenyon and Howell were the individuals named in the agreement with Howell Chevrolet. (R. 58, 59, 112.)

nesses, but also there was no intent to contract and each of the corporations hoped, expected to, and did continue to grow notwithstanding the temporary setback occasioned by the reductions in their capital resulting from the distributions which were made.

\* \* \* \* \*

ultimate dissolution or ultimate contracted operations were never contemplated.

It is clear that the transactions resulted in the distribution of large amounts of current earnings to the shareholders in the guise of stock redemptions, and that when the transactions were completed the taxpayer, Kenyon, Howell and the other shareholders "emerged with the identical fractional interests in the corporation which they had owned before \* \* \*." (R. 42.)

We submit that the Tax Court exercised its function with care in considering all the facts and that its findings and decision are supported fully by the record. It cannot be said that from a review of the record the court below was clearly erroneous in its application of the facts to the statute, the Regulations and the decided cases.

In challenging the Tax Court's determination taxpayer has failed to distinguish between the distributions in redemption of the trust shares (which the Tax Court found were a step in an integrated plan to eliminate the trust as a stockholder and hence were not essentially equivalent to a dividend), and the distributions here in question, which were designed to leave the remaining stockholders including the tax-

payer in the same relative position of ownership and control of the corporations that they previously occupied. Insofar as the redemption of the trust shares is concerned, the arguments advanced by taxpayer were accepted by the Tax Court. But insofar as the redemption of taxpayer's shares is concerned, the arguments have no applicability or validity, and were properly rejected by the Tax Court.<sup>16</sup>

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<sup>16</sup> Moreover, even as to the redemption of the shares here in question taxpayer's argument is replete with inconsistencies. For example, on the one hand taxpayer contends that the redemptions were effected in order to comply with Mr. Connell's "suggestion" that the proportionate ownership and control as between taxpayer and Kenyon be preserved (Br. 26-29, 33-34), yet he also contends that their proportionate interests were changed as a result of the redemptions (Br. 30-32). Again, for example, taxpayer on the one hand contends that the distributions in question did not cause the corporations' capital to fall below the standards required by Chevrolet (Br. 19-22), yet in explanation of non-payment of ordinary dividends during the taxable year he contends that dividend payments were rendered "impossible by the very distributions which are here in question for the reason that such distributions reduced the corporations' working capital below the minimum required for their continued operations" (Br. 31-32).

## CONCLUSION

The decision of the court below is correct and should be affirmed.

Respectfully submitted,

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ELLIS N. SLACK,  
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MAY, 1957

## APPENDIX

## INTERNAL REVENUE CODE OF 1939:

## SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term “dividend” when used in this chapter \* \* \* means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) [as amended by Sec. 147, Revenue Act of 1942, c. 619, 56 Stat. 798] *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation, shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed (whether before January 1, 1939, or



on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. \* \* \*

\* \* \* \* \*

(g) *Redemption of Stock*.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

\* \* \* \* \*

(i) *Definition of Partial Liquidation*.—As used in this section the term “amounts distributed in partial liquidation” means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

\* \* \* \* \*

(26 U. S. C. 1952 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.115-9. *Distribution in Redemption or Cancellation of Stock Taxable as a Dividend*.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend,

the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

United States  
**COURT OF APPEALS**  
for the Ninth Circuit

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LOUIE HOY GAY,

*Appellant,*

vs.

JOHN FOSTER DULLES, Secretary of State of  
the United States of America,

*Appellee.*

---

**APPELLANT'S BRIEF**

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*Appeal from the United States District Court for the  
District of Oregon.*

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FILED

APR - 3 1957

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**United States**  
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LOUIE HOY GAY,

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---

**APPELLANT'S BRIEF**

---

*Appeal from the United States District Court for the  
District of Oregon.*

---

**JURISDICTIONAL STATEMENT**

Appellant filed his complaint to be declared a national and/or citizen of the United States under the provisions of Sec. 503 of the Nationality Act of 1940 (Title 8 U.S.C.A. Sec. 903) in the United States District Court for the District of Oregon.

Following the trial of said cause, appellant's complaint was dismissed by order of District Judge Gus J. Solomon on October 4, 1956 (Tr. 20).

Notice of Appeal was duly filed with the Clerk of this Court (Tr. 21).

Jurisdiction of the District Court to entertain the complaint of appellant declaring him to be a national and/or citizen of the United States, is conferred by Sec. 503 of the Nationality Act of 1940, 54 Stat. 1171 (Title 8, U.S.C.A. Sec. 903) and Sec. 1343 of Title 28 U.S.C.A. Jurisdiction of the Court of Appeals to review the District Court's final order, is conferred by Sec. 128 of the Judicial Code as amended (28 U.S.C.A. 1291). The order of the District Court in dismissing the complaint of appellant for a judgment, declaring him to be a national and/or citizen of the United States, is a final decision within the meaning of Sec. 128 of the Judicial Code.

This case comes within the meaning and interpretation of Sec. 503 and we quote said section:

Judicial Proceedings for Declaration of United States Nationality in Event of Denial of Rights and Privileges as Nationals; Certificate of Indentity Pending Judgment.

"If any person who claims a right or privilege of the United States is denied such right or privilege by any Department or agency, or executive official thereof, upon the ground that he is not a national of the United States, such person, regardless of whether he is within the United States or abroad, may institute an action against the head of such Department or agency in the District Court of the United States for the District of Columbia or in the district court of the United States for the district in which such person claims a permanent residence for a judgment declaring him to be a national of the United States. If such person is outside the United States and shall have initiated such an action

in court, he may, upon submission of a sworn application showing that the claim of nationality presented in such action is made in good faith and has a substantial basis, obtain from a diplomatic or consular officer of the United States in the foreign country in which he is residing a certificate of identity stating that his nationality status is pending before the court, and may be admitted to the United States with such certificate upon the condition that he shall be subject to deportation in case it shall be decided by the court that he is not a national of the United States. Such certificate of identity shall not be denied solely on the ground that such person has lost a status previously had or acquired as a national of the United States; and from any denial of an application for such certificate the applicant shall be entitled to an appeal to the Secretary of State, who, if he approves the denial, shall state in writing the reasons for his decision. The Secretary of State, with approval of the Attorney General, shall prescribe rules and regulations for the issuance of certificates of identity as above provided. Oct. 14, 1940, c. 876, Title I Subchap. V, Sec. 503, 54 Stat. 1171."

## STATEMENT OF THE CASE

Appellant originally filed his complaint through his father, Louie Foo in the District Court for the District of Oregon for a declaratory judgment under Section 503 of the Nationality Act of 1940 (heretofore quoted). Appellant's complaint was thereafter dismissed upon motion and subsequently appealed to this Court and, as a result of said appeal, this Court reversed and remanded the action to the District Court for the District of Oregon for trial. See *Louie Hoy Gay v. Dulles* 225 F. 2d 854.

Thereafter appellant filed an amended complaint (Tr. 3), upon which this cause was tried. The amended complaint contains all of the requisite allegations in this type of case and concludes with a prayer asking that appellant be adjudged a national and/or citizen of the United States.

Evidence was submitted to the Court by the appellant and appellee, and thereafter the Court rendered an opinion (Tr. 12) and Findings of Fact (Tr. 16) and Judgment dismissing appellant's complaint. (Tr. 20). This appeal results.

### **SPECIFICATIONS OF ERROR**

Appellant respectfully contends that the District Court erred in:

1. Finding that appellant had failed to prove by a preponderance of the evidence that the appellant is the son of Louie Foo (Tr. 18).

2. Finding that appellant has failed to prove by a preponderance of the evidence that Louie Foo was a citizen of the United States by birth or naturalization (Tr. 18), and in failing to requiring appellee to rebut prima facie evidence of citizenship by substantial proof of fraud.

3. Admitting into evidence the Immigration file of appellant, being Exhibit No. 14 and that portion of Exhibit No. 7, being the testimony of Louie Hoy Gay and his mother, Ng Shee, taken in Hong Kong (Tr. 46, 100, 101, 102, 103, 106, 107, 111, 112 and 114).



4. Objections to Exhibit 14 and the above mentioned portions of Exhibit 7 were made on the grounds of their being incompetent, irrelevant and immaterial, testimony taken ex parte, and within the rule announced in *Wong Wing Foo v. McGrath*, 196 F. 2d 120, and *Lee Shew v. Brownell*, 219 F. 2d 301, being testimony taken of appellant, his father, Louie Foo, and appellant's mother, before the Immigration and Consular authorities in Hong Kong and in the U. S.

5. Finding that appellant has failed to establish his right to a declaration of United States citizenship pursuant to Sec. 1993, Revised Statutes of the United States.

6. Finding that judgment should be entered dismissing appellant's complaint for failure of proof of allegations of the complaint herein by a preponderance of the evidence.

7. Rendering a judgment that appellant's complaint be dismissed.

## **SUMMARY OF ARGUMENT**

Two questions of fact are presented in this cause:

1. Has the relationship of father and son been established between the appellant, Louie Hoy Gay, and his father, Louie Foo, by a preponderance of the evidence?

2. Was Louie Foo a citizen of the United States at the time of the birth of Louie Hoy Gay and did his citizenship status continue up to the present?

Question 1:

Appellant has shown by a preponderance of the evidence that he is the legal and natural son of Louie Foo and appellee has offered no substantial proof to the contrary.

Question 2:

Louie Foo has shown by prima facie evidence and other evidence that he was a citizen of the United States upon the birth of his son and still is, and that he has a right to remain therein as a citizen.

Appellee did not plead or prove fraud in Louie Foo's claimed United States citizenship or his right to remain in the United States, and the Court erred in making findings that Louie Foo failed to prove by a preponderance of the evidence that he was a citizen. The burden of proof was upon appellee to show by substantial evidence that Louie Foo's claimed right of citizenship and right to remain in the United States were obtained by fraud. No pleading or evidence of fraud was offered by appellee to rebut the prima facie case of citizenship first made, nor was any finding made by the Court to that effect.

A question of law arises as to the admissibility of parts of Exhibit No. 7, being the State Department file on appellant, Louie Hoy Gay, the particular evidence objected to being the testimony of Louie Hoy Gay and his mother, Ng Shee, taken before the American Consul General in Hong Kong. This Court has held that this type of case should be tried de novo. *Wong Wing Foo v. McGrath* (CCA 9 1952), 196 F. 2d 120.

A question of law also arises as to the admissibility of the entire Immigration file on Louie Foo, being Exhibit 14. In *Lee Shew v. Brownell* (CCA 9), 219 F. 2d 301, the Court held that admissions of evidence of record in prior proceedings before the Immigration Service pertaining to admission to the United States is error.

The two questions of fact, having been proven affirmatively by a preponderance of the evidence, would, of necessity, result in a reversal of the Findings 5, 6 and 7 listed in the Specifications of Error.

## ARGUMENT

Rule 52 (a) of Federal Rules of Civil Procedure precludes an appellate court from disturbing findings *unless* they are clearly erroneous. *Yip Mie Jork v. Dulles* (CCA 9), 237 F. 2d 383; *Takehara v. Dulles* (CCA 9), 205 F. 2d 560.

Question 1:

Has Relationship of Father and Son Been Established Between Appellant, Louie Hoy Gay, and His Father, Louie Foo?

Louie Foo testified that Louie Hoy Gay is his son (Tr. 37) and was born July 5, 1908 (Tr. 38); that he made a trip to China in 1907 (Tr. 35) and married his present wife, Ng Shee, in the same year (Tr. 36) and that Louie Hoy Gay was born as a result of this marriage (Tr. 37); that Louie Foo returned to China a second time in 1921 and lived in the same house with Louie Hoy Gay and his wife (Tr. 39), and had sent him

money from the time of his birth up to the time of his second visit to China in 1921 (Tr. 39); that a second child, a girl, was born to Louie Foo and his wife while he was in China on the second visit from 1921 to 1924, and after his return to the United States, he continued to send money to his family (Tr. 40); that Louie Foo has sent money to his wife and boy every few months thereafter (Tr. 109).

A letter from Louie Hoy Gay (Louie Hoy Kee) to Louie Foo, dated October 5, 1929, was introduced into evidence as Exhibit 9, which shows that Louie Hoy Gay asked for money from his father, Louie Foo (Tr. 53, 54). A letter from Louie Hoy Gay (Gar Jok, married name) Exhibit 10 (Tr. 53, 54). This letter reveals the fact that money was received by Louie Hoy Gay from his father, Louie Foo.

Louie Foo sent \$3,000.00 to his wife and family to repair his home (Tr. 55), Exhibit 11 being a letter from Ng Shee, to Louie Foo postmarked 1952. Louie Foo identified a photo of his son, Louie Hoy Gay, which he had in his possession for 16 or 18 years, being Exhibit 8 (Tr. 52).

Blood tests were made of Louie Hoy Gay in Hong Kong and of Louie Foo in Portland, Oregon and were found to be compatible (Tr. 28) and Exhibit 7.

Robert Schmeer, 84 years of age, former vice president of The United Stations National Bank, and now a member of Schmeer Insurance Agency (Tr. 58) testified he has known Louie Foo for 50 years and has seen him almost continuously since that time and that Louie

Foo mentioned to him on many occasions the fact of his having a wife and son in China.

Richard C. Kneeland, Certified Public Accountant for the last 25 years in Portland, Oregon, testified he had known Louie Foo for 25 years, prepared his income tax statements, and that Louie Foo told him he had a son over ten years ago.

Testimony clearly indicates that Louie Hoy Gay is the son of Louie Foo and all records introduced in evidence pertaining to the relationship indicate and always have indicated their relationship of father and son. Prima facie evidence was clearly established.

If the party having the burden of proof establishes a prima facie case, the burden is shifted to the adverse party, 31 C.J.S. 719. If no contradictory evidence is offered, unsupported allegations are not sufficient to overcome the prima facie showing. *Wong Kam Chong v. United States*, 111 F. 2d 707, 712; *Leong Kwai Yin v. United States*, 9 Circ., 31 F. 2d 738; *Fong Lum Kwai v. United States*, 9 Cir., 49 F. 2d 19; *Lee Choy v. United States*, 9 Cir., 49 F. 2d 24.

Even though the prima facie evidence is of a minimum quantity, it is strong enough to raise a presumption, when unrebutted to establish a fact. *Otis & Co. v. Securities and Exchange Commission*, 176 F 2d 34. The appellant has established his claimed relationship by a fair preponderance of the evidence. Once a prima facie claim of United States citizenship has been established, the burden of proving alienage rests upon the government. See *United States v. Todd*, 68 L. Ed. 221, 223.



## Question 2:

Was Louie Foo a Citizen of the United States at the Time of the Birth of His Son and Did His Citizenship Status Continue up to the Present?

Louie Foo, now 73 years of age, testified that he was born in Portland, Oregon, on August 10, 1884 (Tr. 31) and has resided in Oregon ever since; that he now resides on a farm owned by him in Marion County; that he also owns real estate in Multnomah County, Oregon (Tr. 48). He conducted Chinese curio stores in Portland, Oregon, for many years in various locations therein, beginning in 1904 (Tr. 33). He made two trips to China, as outlined above. Louie Foo has always claimed American citizenship and has always held himself out as such with everyone he has come in contact with, including Immigration officials and the witnesses who testified for him at the trial, Mr. Schmeer and Mr. Kneeland, who have known him for many, many years.

Louie Foo was issued a passport by the United States Government as a citizen of the United States on April 3, 1952 (Tr. 43), Exhibit No. 2. Although a passport has been held not to be any evidence of citizenship, it seems odd to the writer that a passport would even be considered for Louie Foo, in view of the position here taken by the appellee, i.e., that Louie Foo never did submit evidence of his birth in connection with his applications for his two trips to China (Tr. 30). Would the State Department be so free in issuing a passport unless they believed that Louie Foo was a citizen of the United States as shown by the evidence in this case.

A decree of registration of birth of Louie Foo as a citizen of the United States was issued to him by the Circuit Court of the State of Oregon on February 8, 1945 (Tr. 43), Exhibit 3.

Section 432.255, Oregon Revised Statutes, provides:  
 "Petition for certificate of unrecorded birth.

(1) Any person who is a resident of or who was born in this state and whose birth is not of record with the State Registrar or of public record in any state of the United States, may file a verified petition with the clerk of the circuit court of any county of this state setting forth as nearly as known to the petitioner:

- (a) The time and place of his birth.
- (b) The name and residence and birthplace of his father.
- (c) The name and residence and birthplace and maiden name of his mother.
- (d) That no public record of his birth exists."

Section 432.280 O.R.S. provides that a certified copy of such record shall be "prima facie" evidence in all courts and places of the facts stated therein. *Mah Toi v. Brownell* (CCA 9, 219 F. 2d 642:

"A birth certificate is prima facie evidence of birth requiring that substantial evidence rebutting the presumption be presented in court."

Section 432.265 provides:

"Prior to filing a petition under ORS 432.255 the petitioner shall serve upon the district attorney of the county wherein the petition is filed a copy of the petition and the district attorney shall accept service upon the original thereof."

The court, in his opinion (Tr. 14), states that neither the Secretary of State, nor the United States, nor any agency thereof, was a party to these proceedings and are not bound by this decree. The above stated provision of the Oregon law requiring that the petition shall be served on the District Attorney before it is filed is a prerequisite to a hearing of said petition, which was complied with herein.

Louie Foo was issued a certificate of identity No. 54325 as a merchant by the Immigration officials at Seattle, Washington, on November 30, 1924, upon his second return from China (Tr. 44), Exhibit 4. This certificate of identity entitles him to remain in the United States and is a prima facie right of the holder to remain in the United States. *Choy Yuen Chan v. United States* (CCA 9), 30 F. 2d 516:

“In the absence of a charge that an act had been committed which justifies his deportation, or some affirmative proof of the Government that he obtained admission fraudulently, the holder of such a certificate is entitled to remain in the United States.”

*Leong Kwai Yin v. U. S.*, 31 F. 2d 738. Quoting from said certificate of identity:

“Certificate of identity issued to a Chinese person pursuant to rules of immigration is prima facie evidence of the holder to remain in the United States until overcome by proof that it was fraudulently obtained.”

In the case of *Fong Lum Kwai v. United States*, 49 F. 2d 19, CCA 9, Judge Wilburn, speaking for the court, said:

"In *Wong Yee Toon v. Stump*, 233 F. 194, 196, by the Circuit Court of Appeals of the Fourth Circuit, it is said: 'After the certificate (of identity) is issued, it is our view that the burden is cast upon the government, in case a proceeding is instituted to attack it, to show by testimony which the law recognizes as evidence that it should be annulled before an order for deportation is warranted.' This was cited with approval in our decision in *Lum Man Shing v. U. S.*, 29 F. (2d) 500, 502, where this court held that the certificate of identity issued under rule 20 of the Rules of Immigration, Department of Labor, to a Chinese person who had entered the Hawaiian Islands at Honolulu, was sufficient prima facie proof to establish the right of the holder to remain in the United States \* \* \*

"There was no evidence in this record to overcome the presumption arising from the findings of the Board of Special Inquiry."

*Yue Boo Ming v. United States*, 103 F. 2d 355.

Louie Foo registered for the United States Army draft in both World Wars on September 12, 1918, and on April 26, 1942, respectively (Tr. 44), Exhibit 5.

Louie Foo was a registered voter in Multnomah County, Oregon, and voted from 1928 to 1941 (Tr. 47 and 72), Exhibit 12. This early record discloses that Louie Foo voted in a primary election on May 18, 1928, and in a general election on November 6, 1928.

Robert W. Schmeer, previously mentioned, testified that he has known Louie Foo for approximately 50 years almost continuously (Tr. 60); that he always paid back his loans from the bank "on the dot;" that he always claimed to be a United States citizen (Tr. 62 and 67).

Louie Foo has always claimed American citizenship by birth and Immigration authorities have known of this claim since his first visit to China in 1908 and have never denied his right to come and go, or his claims of citizenship, nor have they brought deportation proceedings against him since that time. Does it not seem that appellee is now estopped to deny his citizenship from the foregoing facts?

In the case of *Chin Wing Dong v. Clark*, 76 F. Supp. 648 (CCA 9), the Immigration Service was not satisfied whether a man was a citizen or not, hence no steps were taken to furnish him evidence that he was a citizen, or any steps taken toward deporting him as an alien. In passing the court said:

“From all such testimony, records and other exhibits, it was established that the petitioner had not only registered for and been inducted in the United States Army during the first World War as a citizen of the United States, but that he held himself out to be such a citizen and had been recognized as such by all with whom he came in contact, except on some occasions, by the Immigration and Naturalization Service, as previously related. For instance, he bought and held real property, paid taxes, registered as a voter and regularly cast his ballot in numerous elections. He established an excellent reputation as an honest law-abiding citizen. I am mindful that in effect the Department merely argues against granting him the affirmative relief of decree of citizenship, and that there has been no effort nor intention of deportation. In other words, it is implied that the petitioner may live here, exercise the rights of citizenship, and even vote, but that the Court should deny him a decree that he is the citizen that in fact he is. *To require him to continue in the legal twilight of such uncertainty is*



*neither fair to him nor worthy of this Government."*  
(Italics ours.)

The evidence clearly identified appellant as the lawful son of Louie Foo and the evidence clearly identifies Loui Foo as a citizen of the United States since his birth in Portland, Oregon, up to and including the present time.

The appellant offered into evidence the State Department file (Exhibit No. 7) with the exception of the testimony contained therein of appellant and his mother, which was taken before the Immigration authorities in Hong Kong (Tr. 46).

Appellee introduced that part of Exhibit 7 containing the testimony of appellant and his mother taken in Hong Kong (Tr. 100) and was admitted by the Court (Tr. 103), and appellee was then permitted to question Louie Foo upon the testimony given by his wife, which was taken in Hong Kong. The Court again said he did not think this admissible but allowed the testimony (Tr. 107).

The Court admitted the immigration file of Louie Foo (Tr. 111, 112, 114) which was objected to by counsel for appellant (Tr. 112).

The Court stated, in his opinion (Tr. 15) that he considered plaintiff's (appellant's) statements referred to in the immigration file. The question concerning introduction of immigration records and the right to a trial de novo in citizenship proceedings has been ruled on by this Court in *Wong Wing Fu v. McGrath*, 196 F. 2d 120; *Lee Shew v. Brownell*, 219 F. 2d 201, and *Mah Yong Og*

*v. Clark*, 81 F. Supp. 696, 697. It has also been held that a document is not admissible to prove the facts, which it recites. See *United States v. International Harvester Co.*, 274 U.S. 693. This Court, in *Lee Choy v. United States*, 49 F. 2d at p. 27, concluded that improper introduction of certain immigration records was reversible error. The Court stated:

“It thus appears that the Court unconsciously allowed the erroneously admitted record to influence him in consideration of the case. This is a striking illustration of the danger of getting into the record evidence not admissible under well-recognized rules. If these records were controlling in the decision of the case, it would seem that the defendant should be discharged from custody. In judicial proceedings the court is restricted in the reception of evidence to only such as meets the requirements of legal proof.”

The evidence clearly identifies appellant as the lawful son of Louie Foo and the evidence clearly identifies Louie Foo as a citizen of the United States since his birth in Portland, Oregon, up to and including the present time.

## CONCLUSION

It is submitted that the proceeding in the District Court was a trial de novo and not a review of the administrative hearing. The admission into evidence of the whole Immigration file and designated parts of the State Department file was incompetent and inadmissible evidence. Appellant not only established a prima facie case showing his claimed relationship with his father and that his father was a citizen of the United States, but

established these facts by substantial evidence. No competent evidence was offered by appellee to controvert this showing.

It is respectfully requested that the judgment of the lower court be reversed and that appellant be declared to be a United States citizen and/or national.

Dated at Portland, Oregon, March 26, 1957.

BANKS & BANKS,

By RODNEY A. BANKS,  
*Attorneys for Appellant.*



United States  
**COURT OF APPEALS**  
for the Ninth Circuit

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LOUIE HOY GAY,

*Appellant,*

vs.

JOHN FOSTER DULLES, Secretary of State of  
the United States of America,

*Appellee.*

---

**APPELLEE'S BRIEF**

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*Appeal from the United States District Court for the  
District of Oregon.*

---

C. E. LUCKEY,  
United States Attorney,  
District of Oregon,

VICTOR E. HARR,  
Assistant United States Attorney,  
*Attorneys for Appellee.*

FILED

APR 29 1957

PAUL P. O'BRIEN, CL.





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**United States**  
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**APPELLEE'S BRIEF**

---

*Appeal from the United States District Court for the  
District of Oregon.*

---

**OPINION BELOW**

Opinion of the District Court (R. 12), Findings of  
Fact and Conclusions of Law of the District Court (R.  
16-19) and Judgment (R. 20).

**JURISDICTION**

Jurisdiction of the District Court is invoked under  
Section 503 of the Nationality Act of 1940 (Title 8,  
USCA, Section 903). Jurisdiction of the Court of Ap-  
peals is invoked under the provisions of Title 28, USCA,  
Section 1291.

## **STATUTES INVOLVED**

Section 503 of the Nationality Act of 1940, 54 Stat. 1171. Title 8 USCA 903. [Quoted in its entirety by Appellant (App. Br. 2 & 3).]

Sec. 1993, Revised Statutes.

“All children heretofore born or hereafter born out of the limits and jurisdiction of the United States, whose fathers were or may be at the time of their birth citizens thereof, are declared to be citizens of the United States; but the rights of citizenship shall not descend to children whose fathers never resided in the United States.”

## **STATEMENT OF THE CASE**

The appellant herein claims to be the son of Louie Foo, a resident of the State of Oregon and an alleged citizen of the United States, at the time of his birth in China. Appellant claims derivative citizenship under Revised Statute 1993.

The material portions of the complaint in issue are as follows:

### **I.**

“That Louie Hoy Gay, the plaintiff, is a citizen of the United States. \* \* \*

### **IV.**

“That the plaintiff, Louie Hoy Gay, was born on July 5, 1908, at Hong Me Village, Toy Sun District, Canton Province, China, and now resides at Number 4, Winglok Street, Hong Kong, China, and is a citizen of the United States under Section 1993 of the Revised Statutes, 8 U.S.C. 6, First Edition.



## V.

"That Louie Foo, the father of plaintiff, Louie Hoy Gay, was born in the City of Portland, Multnomah County, State of Oregon, on August 10, 1884, and ever since that time said Louie Foo has been and now is a citizen of the United States \* \* \*"

The answer to the complaint denies each of said allegations.

From a decision denying the petition for a declaration of citizenship, plaintiff appeals.

The sole issues, therefore, to be determined are as stated in the Judge's opinion (R. 12) as follows:

"In order to prevail, plaintiff must prove by a preponderance of the evidence (1) that he is the legal and natural son of Louie Foo and (2) that Louie Foo at the time of plaintiff's birth was a citizen of the United States."

In the Court's opinion (R. 15) two references are made to portions of the Immigration and Naturalization file. The first reference pertains to the interview of appellant and his alleged mother as conducted in Hong Kong by the American Consulate in connection with his application for passport. The second reference states that the Court only considered the statements of plaintiff's and documents submitted either by him or on his behalf. Clearly, the Court in each of these instances had reference to the passport file of the Department of State which was plaintiff's exhibit 7 and not the Immigration & Naturalization file (Def. Exh. 14).

## **SPECIFICATIONS OF ERROR**

Appellant has stated 7 specifications of error, but treats them collectively under two questions which, in substance, were stated in the opinion of the Court below (R. 12).

## **QUESTIONS PRESENTED**

The District Court in its opinion (R. 12) correctly sets forth the questions herein to be considered as follows:

“In order to prevail, plaintiff must prove by a preponderance of the evidence (1) that he is the legal and natural son of Louie Foo and (2) that Louie Foo at the time of plaintiff's birth was a citizen of the United States.”

## **SUMMARY OF ARGUMENT**

1. Plaintiff has failed to prove by a preponderance of the evidence that he is the legal and natural son of Louie Foo.

## **ARGUMENT**

The record shows that Louie Foo, a Chinese resident of the State of Oregon, went to China in the year 1907. In March 1907, he claims to have married a Chinese woman by the name of Ng Shee. Of this union, Louie Foo claims that on July 5, 1908, after he had returned to the United States from his trip to China, a son was born (R. 38). Louie Foo testified that this

child was named Louie Hoy Gay, and although an objection was made to this testimony (R. 37) the Court permitted the answer to stand. When Louie Foo returned to China on his next trip in 1921, he testified that the boy was then 13 or 14 years of age (R. 39). The Court had before it the entire passport file of the Department of State which, with the exception of the questioning of the plaintiff and his alleged mother at the Office of the American Consulate at Hong Kong, was introduced into evidence by Appellant (Def. Exh. 7). The balance of the State Department passport file was offered in evidence by Appellee and the same was admitted into evidence subject to Appellant's objection and the Court commented (R. 100) that he would decide later on whether or not it would go into evidence. In rendering his opinion, the Court apparently considered all of this record in its entirety except the questions and answers propounded to plaintiff's alleged mother, Ng Shee. This questioning was determined by the Court below to be inadmissible under the Rule of *Wong Wing Foo v. McGrath*, 9 Cir. 1952, 196 F.2d 120. Obviously, the only person having actual knowledge as to whether or not the plaintiff, Louie Hoy Gay, was in fact the son of Louie Foo, was the mother. The questions and answers as aforesaid propounded to the alleged mother by the interrogator in the Office of the American Consulate in Hong Kong would have contributed direct evidence of the relationship. This evidence was not considered since it was objected to by plaintiff himself. The interrogation of plaintiff in the Office of the American Consulate at Hong Kong was

admitted into evidence and the Court below, as did the interrogating officer at Hong Kong, considered the testimony of plaintiff very unsatisfactory. This part of Appellant's Exhibit 7 was clearly admissible under Title 28, Sec. 1733, "(a) Books or records of account or minutes of proceedings of any Department or Agency of the United States shall be admissible to prove the act, transaction or occurrence as a memorandum of which the same were made or kept; \* \* \*." See also *Lee Dong Sep v. Dulles*, CA 2, 220 F.2d 264. While the testimony of appellant contained in Exhibit 7 to the effect that he was the blood son of Louie Foo, and Louie Foo at the trial of this cause gave similar testimony (R. 37), all of which was uncontradicted, the Court below was not required to nor did he believe such evidence, nor did he accept it as true. See *Ly Shew v. Dulles*, CA 9, 219 F.2d 413, and cases cited therein.

On the basis of the testimony and proof submitted, the Court was justified in determining that it could not base a finding of citizenship upon testimony of that quality.

## **SUMMARY OF ARGUMENT**

2. If the Court below was justified in determining that plaintiff had not sustained the burden of proof of the fact that he was the son of Louie Foo, then that would be determinative of the within controversy or if the Court below was in error at arriving at its said determination or considered evidence which should not have been admitted (which appellee denies), then plain-

tiff had the burden of proving by a preponderance of the evidence that Louie Foo was in fact a citizen of the United States at the time of plaintiff's birth.

At the trial of this cause appellant placed reliance to prove this issue upon:

(a) United States passport issued to Louie Foo on April 3, 1952 as a citizen of the United States (Exh. 2).

(b) A Delayed Decree for Registration of Birth issued to Louie Foo on February 8, 1945, out of the Multnomah County Circuit Court for the State of Oregon, issued pursuant to Section 432.255, Oregon Revised Statutes (Exh. 3).

(c) Certificate of Identity, No. 54325 as a Merchant issued to Louie Foo by Immigration Officials, Seattle (Exh. 4).

(d) United States Army draft registration of Louie Foo (Exh. 5).

(e) Voting registration in Multnomah County, Oregon, from 1928 to 1941 (Exh. 6).

With the exception of plaintiff's delayed birth registration which appellee admits is prima facie evidence of birth, none of the other aforesaid exhibits have any legal weight as tending to prove the citizenship of Louie Foo. It is further contended by appellee that (Def. Exh. 14) the Immigration & Naturalization file concerning Louie Foo was properly admissible for impeachment purposes (R. 112). Any presumption that may have resulted in appellant's favor by virtue of the delayed birth registration, was fully overcome in cross examination of Louie Foo, and the Court was fully justified in determining as he did in referring to the answers of Louie Foo to the interrogatories of the Immigration & Naturalization Service that, "His answers to these interrogatories con-



cerning his early life and his parents were just as vague and just as unsatisfactory as his testimony at the trial." The Court's finding No. VII (R. 18), "That plaintiff had failed to prove by a preponderance of the evidence that said Louie Foo was a citizen of the United States by birth or naturalization" was correct and fully justified.

## ARGUMENT

Taking up the contentions of appellant in the order in which they are set forth in his brief, the first contention being (a) that Louie Foo was issued a passport by the United States government as a citizen of the United States on April 3, 1952, being Exhibit 2.

" \* \* \* A passport, when granted, is not conclusive, nor is it even evidence, that the person to who it is granted is a citizen of the United States." *Urtetiqui v. D'Arcy*, 9 Pet., 9 L. Ed. 276.

Counsel argues that it is unlikely that the State Department would issue a passport (Exhibit 2) unless they believed that Louie Foo was a citizen of the United States. We do not consider it necessary to argue this point further since counsel admits that the issuance of a passport "has been held not to be any evidence of citizenship, \* \* \*" (Br. 10).

(b) Decree of delay registration of birth—Section 432.280 ORS (Exh. 3).

No better argument can be made here regarding the weight that should be accorded to Exhibit 3 than that which appears in the opinion of Judge Solomon (R. 13 and 14) as follows:

“Plaintiff placed great reliance on a delayed decree for registration of birth issued to Louie Foo on February 8, 1945, showing that he was born on August 10, 1884. This decree was taken *ex parte*, and it was issued pursuant to Oregon Revised Statutes 432.280, which provides that a certified copy of such record ‘shall be *prima facie* evidence in all courts and places of the facts stated therein.’ This order recites:

‘Testimony of petitioner supporting allegations of Petition and that he is the owner of valuable real estate in Marion and Multnomah Counties in Oregon. Testimony of W. W. Banks, a reliable attorney, to the effect that he has personal acquaintance with and done legal services for petitioner for more than 40 years and that he has been a merchant during all of the time.’

“This abstract of supporting evidence clearly indicates the unsatisfactory basis upon which the order was issued. Neither the Secretary of State nor the United States nor any agency thereof was a party to these proceedings and are certainly not bound by this decree. *Ex parte, Lee Fong Fook*, D.C.N.D. Calif. 1948, 74 F. Supp.; *U. S. vs. Casares-Moreno*, D.C.S.D. Calif. 1954, 122 F. Supp. 375.”

See also *Marcelino Casares-Moreno v. United States of America*, CA 9, 226 F.2d 873, and *Mah Toi v. Brownell*, CA 9, 219 F.2d 642.

At best, this decree for delayed registration of birth is merely *prima facie* evidence of birth. It is not conclusive. In discussing the evidentiary weight of a birth certificate, this Court in the case of *Mah Toi v. Brownell*, *supra*, quoted with approval the following language from the case of *Otis & Co. v. Securities & Exchange*

*Commission*, 85 U.S. App. D.C. 122, 176 F.2d 34, 42, as follows:

“Prima facie evidence is a minimum quantity. It is that which is enough to raise a presumption of fact; or, again, it is that which is sufficient, when unrebutted, to establish the fact.”

But counsel urges (Br. 9) that since the said Decree of Registration of Birth is prima facie evidence of birth, that the burden of proof shifted to the adverse party. We do not agree that this is a correct statement of the law. Again referring to *Mah Toi v. Brownell*, supra, the Court stated:

“Appellant concedes that if the superior court order was not conclusive evidence of the fact of appellant’s native birth as a matter of law, its admission in evidence did not shift the burden of proving the fact, but merely required that substantial evidence rebutting the presumption be presented to the court, \* \* \*”

The question then would appear to be, is there sufficient evidence in the record to sustain the Trial Court’s finding of fact, at least to the extent of evenly balancing the weight of all the creditable evidence with no preponderance thereof in favor of the appellant.

Reference is made to the memorandum dated September 30, 1952, covering the testimony taken from Louie Hoy Gay in connection with his passport application (Def. Exh. 7, P. 3). Appellant testified that his grandmother had never been in the United States; that his father was actually born in Hung May Village, Toishan, 1884, and that his claim to American citizenship was by reason of the naturalization of his father in

the United States which he states was at a fairly recent date. He stated that his father had written him advising him of this fact. I think it is fair to assume that this reference to the father having become a naturalized citizen had reference to the Decree for Registration of Birth granted by Circuit Judge Walter L. Tooze on February 8, 1945 (Exh. 3).

A very interesting point presents itself through a question propounded by the court to Mr. Banks when he was making his opening statement (R. 27): "Why was he admitted on those two trips as a Chinese merchant rather than as a citizen? Mr. Banks: I will tell you why, your Honor. It is because it was much easier for a merchant to go than it was to offer proof of his citizenship, and that is the reason why that was done, but at all times on those two trips and at all times since he has claimed to be a citizen of the United States."

In Mr. Banks' opening statement (R. 30) in mentioning the different places where appellant's business was moved, he stated that this business "continued up to 1946 when a fire, if you will remember, up Washington Street, destroyed their store." See also Mr. Banks' statement (R. 50) when he said, "I have got \$7,000.00 insurance when that was destroyed in 1946, and he had many valuable documents in his trunk in the basement of that store, as he told you about, records of monies sent home, records of correspondence with his family, all that sort of thing." Louie Foo also testified that the fire occurred in the year 1946 (R. 77). Mr. Foo was then cross examined with reference to the contents of

his trunk in the basement of his business establishment (R. 96). He was asked the question:

“Q. Mr. Foo, in your testimony about the fire you said you had a trunk in the basement and you had a lot of personal belongings there?

A. Yes, sir.

Q. Or at least you said you had some photographs there?

A. Yes.

Q. Did you have any other evidence besides these photographs of the fact that you were born in this country?

A. I got birth certificate, photographs, fire burn up in the trunk.

Q. Did you have any evidence at all of your being born in this country?

A. Yes, sir.

Q. What was that evidence?

A. Some paper, birth certificate and photograph; all burned.

Q. That is the reason it has made it difficult now for you to prove your birth; is that right?

A. Yes.

Q. If you had that evidence that was burned in the trunk, then you would have that birth certificate, photographs and some papers; is that right?

A. Yes.”

This testimony seems incredulous. If he did in fact have a birth certificate in his trunk at the time of the fire in 1946, then why did he find it necessary to file a petition in the Circuit Court of the State of Oregon and appear before Judge Walter Tooze in February 1945 to secure a decree for delayed registration of his birth. It is to be remembered that this witness has testified that he operated a business for approximately 42 years; that he waited on the customers who were principally English-speaking people; that he took a business course in the



YMCA. Certainly the cross examiner did not attempt to confuse Mr. Foo; the testimony of his having a birth certificate, etc., was entirely voluntary on his part, and being a well educated man, he certainly knew what he was talking about. Therefore, in stating that he had a birth certificate in 1946, I think it can safely be said that Louie Foo was not telling the truth. This is not reliable testimony.

In appellee's statement of the case herein, attempt was made to clarify what is unquestionably a misstatement made by the Court in his opinion, when reference was made to the "Immigration & Naturalization file" (R. 15), when in fact the Court was referring to the Department of State passport file. The Court was talking about Exhibit 7, since he referred to the interviews conducted at Hong Kong and plaintiff's application for passport. This, then, could only pertain to the Department of State passport file. Appellant, in his brief (Br. 15) also makes the same error when he refers to "plaintiff (appellant's) statements referred to in the Immigration file" as having been considered by the Court and therefore he states that under *Wong Wing Foo v. McGrath*, 196 F.2d 120; *Lee Shew v. Brownell*, 219 F.2d 301, and *Mah Yong Og v. Clark*, 81 F. Supp. 696, and other cases cited (Br. 16), the Court was in error in admitting this document into evidence. As was heretofore stated the passport file was admissible under 28 USCA 1733, and *Lee Dong Sep v. Dulles*, *supra*.

Appellee introduced the Immigration & Naturalization file (Def. Exh. 14), solely for impeachment purposes (R. 112). Louie Foo made two trips to China and

upon his return each time, was interrogated by the Immigration & Naturalization agents. Certain impeaching questions were asked Mr. Foo under cross examination. Louie Foo had acknowledged these interrogations and acknowledged he had signed the documents about which he was being questioned.

“ \* \* \* It is legitimate crossexamination to confront a witness with former statements and permit or request him to explain.

“The trial before the district court was, of course, de novo and not a review of the Immigration hearings and the record shows that the court considered all of the evidence in that light.” *Wong Ken Foon v. Brownell*, CA 9, 218 F.2d 444, 446.

See also *Lee Dong Sep v. Dulles*, *supra*.

On November 30, 1924 and again on December 4, 1924, when Louie Foo returned from China after making his second trip to that country, he reported that he had had another child, whose name was Louie Hoy Park, a son, age 2 years. He denied having any daughters. At the trial he stated that in addition to his son Louie Hoy Gay, he also was the father of one daughter (R. 40, 80, 82). He testified that his daughter's name was Louie May Kin. He denied making the statement to the Immigration Department in 1924 that he had reported the birth of a son, Louie Hoy Park, 2 years old. He stated, “I all the time say I got one boy and one girl, that is all. Maybe someone make a mistake.” (R. 82). He was cross examined at some length in this regard, but maintained throughout that he only had the two children, the appellant herein and one daughter. It is significant, however, in referring to the Immigration & Naturaliza-

tion file (Def. Exh. 14), in three documents, all signed by Louie Foo, he reported the birth of another son, Louie Hoy Park. The first statement appears on Form M 149 entitled "Chinese Landed Direct from Steamer on Identification," dated November 30, 1924. The second statement was made in his interrogation on December 4, 1924, where he was asked if he had ever had any other children other than these two sons, and his answer was "No." At that time, he also denied having any daughters. Further in this connection is a document in the Immigration file next following the interrogation of December 4, 1924, being Form No. 256 entitled "Application for Immigration Visa (Nonquota)," subscribed and sworn to by Louie Foo before the American Vice Consul at Hong Kong and bearing the American Consulate seal. In the body of this form, Louie Foo stated the names and places of residence of his minor children as being:

"Louie Hoy Kay, male, address, Hang Mee Vil., Toy Shan, China.

Louie Hoy Park, male, address                      do "

On the back of this form will be noted the picture of Louie Foo with his signature thereon and a cancellation of the fee stamp and also the seal of the American Consulate imprinted so as to partially cover the photograph of this witness, Louie Foo. While this is strictly impeaching testimony and perhaps should be considered only in determining the weight that should be given to Louie Foo's testimony as a whole, it is inconceivable that a mistake could have been made by three separate government officials to whom Louie Foo reported the birth of

a second son. The testimony of Louie Foo at the trial of this case in this regard must necessarily be false or, in the alternative, the testimony given to the American Vice Consulate at Hong Kong and to the Immigration officials at Seattle was false. Further, in reviewing the transcript of testimony to determine the weight and credibility to be given to the testimony of Louie Foo, this Court will note that although Louie Foo asserted that his parents returned to China when he was but a small boy, he was extremely vague as to incidents concerning his childhood. While the self-serving statements of appellant and his alleged father with reference to Louie Foo's having been born in the United States were not contradicted by direct evidence, yet their testimony was so contradictory and unsupported that it was not worthy of belief. Therefore, any burden that was imposed upon the government to rebut any presumption that may have existed by virtue of the decree of delayed registration of the birth of Louie Foo, has surely been fully overcome.

The Court below was fully justified in determining as he did when referring to the testimony of Louie Foo (R. 13):

"The Immigration and Naturalization file \* \* \* contains numerous documents which show questions propounded to him by immigration officials and his answers. The great bulk of these documents are dated from 1907 to 1924. They show that, as early as 1907, he was requested to submit proof of his citizenship and that this request was repeated on several occasions thereafter. His answers to these interrogatories concerning his early life and his parents were just as vague and just as unsatisfactory as his testimony at the trial."

This Court said in *Wong Ken Foon v. Brownell*, *supra*:

“Some of the testimony of the alleged father and of the alleged son was in the judgment of the court inherently improbable and unbelievable.”

This Court further stated in *Lew Wah Fook v. Brownell*, 218 F.2d 924, 925:

“The guardian says he is the ward’s father, and the ward says the guardian is his father. ‘The mere say-so of interested witnesses does not have to be accepted \* \* \*.’ *Flynn ex rel. Yee Suey v. Ward*, 1 Cir., 104 F.2d 900-902. See *Siu Say v. Nagle*, 9 Cir., 295 F. 676, wherein is stated: ‘In cases of this character experience has demonstrated that the testimony of the parties in interest as to the *mere fact of relationship cannot be safely accepted or relied upon* \* \* \*.’”

- (c) Certificate of Identity, No. 54325 as a merchant, issued to Louie Foo by Immigration officials, Seattle (Exh. 4).

The most that can be said for this contention by appellant is to adopt counsel’s language (Br. 12): “This certificate of identity entitles him to remain in the United States and is a *prima facie* right of the holder to remain in the United States.” Then follows citation of three cases pertaining to deportation proceedings instituted against the holder of such a certificate of identity. These cases have no pertinency to the issues presented in this case. We are not trying a deportation case against Louie Foo. There is no contest at present pertaining to the right of Louie Foo to remain in the United States. The issue is whether Louie Foo was a citizen of the



United States at the time of the birth of his alleged son, Louie Hoy Gay. The certificate of identity issued to Louie Foo is no evidence whatsoever that he was ever considered to be a citizen of the United States.

(d) United States Army Draft Registration of Louie Foo (Exh. 5).

(e) Voting Registration of Multnomah County, Oregon, from 1928 to 1941 (Exh. 6).

These two contentions will be considered together. Appellant makes no contention that the mere fact that Louie Foo registered for the United States Army draft in both world wars is any evidence at all that he is a citizen of the United States. Neither does he contend that because of the fact that Louie Foo registered as a voter in Multnomah County, Oregon in the years stated is to be treated as evidence of citizenship of this individual. Counsel does cite the case of *Chin Wing Dong v. Clark*, 76 F. Supp. 648 (DC WD Wn., N.D.), in support of his position. However, a reading of that case clearly distinguishes it from the present case. In that case, the plaintiff was admitted in 1908 at San Francisco, as the Chinese-born son of an American-born father. Subsequently, a certificate of citizenship was denied the petitioner and eventually a suit was filed under the Nationality Act of 1940, 8 USCA 903, for a judicial declaration that he was a citizen of the United States and that he had been denied the rights and privileges as such. This case was apparently filed in 1947 and Judge Black rendered his decision in the State of Washington on February 18, 1948. Louie Foo was never ad-

mitted into the United States as a citizen nor has he ever been recognized as such. He at all times was fully aware that his citizenship was in dispute, but he has never seen fit to bring a 503 suit so as to have a judicial determination of his claim to citizenship. Under all of the evidence submitted in the *Chin Wing Dong* case, Judge Black determined that by the preponderance of the evidence, the petitioner was entitled to a decree of the court determining him to be a citizen of the United States. We do not see how that case is pertinent to the issues herein involved.

The Court below, in determining that plaintiff has failed to prove by a preponderance of evidence that he is the son of Louie Foo, and further, that plaintiff has failed to prove by a preponderance of the evidence that said Louie Foo was a citizen of the United States by birth or naturalization, was fully justified and surely was not clearly erroneous (Rule 52(a), Federal Rules of Civil Procedure). Under this rule, the appellate court is precluded from disturbing the findings of the Court below unless they are clearly erroneous.

## CONCLUSION

The evidence presented by plaintiff was vague, contradictory and unsatisfactory. The Court below had the opportunity to observe the witnesses and the manner in which they testified, and was thereby fully capable of determining the weight and credibility to be given to the testimony offered on behalf of plaintiff. His decision in denying the petition of plaintiff should be affirmed.

Dated, Portland, Oregon, April 26, 1957.

Respectfully submitted,

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United States  
**COURT OF APPEALS**  
for the Ninth Circuit

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LOUIE HOY GAY,

*Appellant,*

vs.

JOHN FOSTER DULLES, Secretary of State of  
the United States of America,

*Appellee.*

---

**APPELLANT'S REPLY BRIEF**

---

*Appeal from the United States District Court for the  
District of Oregon.*

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FILED

MAY - 9 1957

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---

*Appeal from the United States District Court for the  
District of Oregon.*

---

**QUESTIONS PRESENTED**

The fundamental issues to be determined by this appeal are three, namely:

1. Is appellant Louie Hoy Gay the lawful and natural blood son of Louie Foo?
2. Is Louie Foo a native born citizen of the United States?
3. Did the trial court err in admitting in evidence the Immigration file of plaintiff (appellant), be-

ing Exhibit No. 14, and that portion of Exhibit No. 7, being the testimony of Louie Hoy Gay and his mother, Ng Shee, taken in Hong Kong (Tr. 46, 100, 101, 102, 103, 106, 107, 111, 112 and 114)?

## **ISSUE NO. 1**

Replying to appellee's Summary of Argument stated on page 4 of appellee's brief, to-wit, "that Plaintiff has failed to prove by a preponderance of the evidence that he is the legal and natural son of Louie Foo," we submit to the court the following:

## **ARGUMENT**

We believe that, in our original brief, we have fully met appellant's contention on this issue, wherein we have specifically recited the evidence of a long chain of events and supporting legal authorities, which fully refute the contention of appellee and establishes by a preponderance of the evidence that appellant, Louie Hoy Gay, is the lawful and natural blood son of Louie Foo.

Desiring to avoid repetition, we refer the court to said evidence and authorities contained in our original brief. We desire, however, to add one additional item, as follows:

A blood test was taken of Ng Shee, the mother of Louie Hoy Gay, and Louie Hoy Gay, in China, by Eric Vio, M.D., as indicated by his letter dated September 1, 1952, and contained in Exhibit No. 7. This letter indicates that the blood was compatible between mother and son.

A letter from Arthur W. Frisch, M.D., of the University of Oregon, is contained in Exhibit No. 7, which indicates that the blood type of Louie Foo is compatible with that of his son, Louie Hoy Gay.

## **ISSUE NO. 2**

Is Louie Foo a native born citizen of the United States?

Louie Foo was 72 years old at the date of trial on February 8, 1956, and was born on August 10, 1884 at Portland, Oregon (Tr. 31).

The appellate court will recognize the difficulty of one that age to produce witnesses of actual birth, as such witnesses would have to be approximately 90 years of age (Tr. 49). Even the trial court recognizes this difficulty (Tr. 113, 114). The law requires only that Louie Foo prove by a preponderance of the evidence that he is a citizen of the United States. All decisions which previously placed a greater burden on him, namely, to prove citizenship by clear and satisfactory evidence, have now been overruled (Tr. 114). To prove his citizenship, Louie Foo has, by his testimony, bared in detail the history of his life from his birth at Portland, Oregon on August 10, 1884, to the date of trial on February 8, 1956 (Tr. 31 to 57 inclusive). He has fortified his testimony by ample evidence of witnesses and evidence of a chain of facts and circumstances which, we believe, proves his claim of citizenship by a preponderance of the evidence (Tr. 31 to 57 inclusive).

We urge the court to read Louie Foo's testimony in its entirety.



For the sake of brevity, and in order to avoid repetition, we refrain from repeating much of the testimony, facts and circumstances and the law applicable thereto, contained in our original brief on appeal.

We wish to refer to the statement made in appellee's brief on page 11, as follows:

"A very interesting point presents itself through a question propounded by the court to Mr. Banks when he was making his opening statement (R. 27):

" 'Why was he admitted on those trips as a Chinese merchant, rather than as a citizen?

" 'Mr. Banks: I will tell you why, your Honor. It is because it was much easier for a merchant to go than it was to offer proof of his citizenship, and that is the reason why that was done, but at all times on those two trips and at all times since he has claimed to be a citizen of the United States.' "

The statement by Mr. Banks, just quoted, is very, very true.

The court will observe that a Certificate of Identity issued to Louie Foo by the Immigration officials at Seattle, No. 54325, as a result of an application by Louie Foo to go to and return from China as a merchant pursuant to rules and regulations of the Immigration Department (Tr. 44), under which a Chinese merchant desiring to depart for China could file an application with said department to depart to and return from China, if he was a bona-fide Chinese merchant, and his application be signed by two white witnesses, who had known the applicant for more than one year and that said applicant had done no manual labor, except what was necessary in the conduct of his business.

That was the simple method and justified the statement made by Mr. Banks that the reason why Louie Foo had not made application as a citizen on his two trips to China was that it was easier to go as a merchant, rather than as a citizen. Certificates of identity were issued by the Immigration Department on the return of the applicant such as the one above mentioned.

One has only to reflect the difficulty encountered in the present case to understand the truth of Mr. Banks' statement.

On the question of whether or not Louie Foo has produced sufficient evidence to prove by a preponderance of the evidence that he is a citizen of the United States we place great emphasis on the case of *Chin Wing Dong v. Clark*, 76 F. Supp. 648 (CCA 9), referred to in appellant's original brief at Page 14.

The court will find in that case the testimony, records and exhibits were very similar to those introduced in evidence on behalf of Louie Foo. It is an excellent authority, fully supporting appellant's contention as to citizenship.

Appellee, in his brief at page 14, places great stress on the fact that, on November 30, 1924, and again on December 4, 1924, when Louie Foo returned from China, after making his second trip to that country, he reported that he had another child, whose name was Louie Hoy Park, a son, aged 2 years. At the trial Louie Foo stated:

"I all the time say I got one boy and one girl. That is all. Maybe someone make a mistake."

Bearing on this subject, we call the court's attention to the case of *United States ex rel Fong Lung Sing v. Day*, 26 F. 2d 619. In this case Fung Lung Sing was a native of the United States and made two trips to China and returned, the last trip being in 1911. Upon his entry into the United States in 1911, he testified he had one son. In 1917 Fong Bing Thin applied for entry as the son of Fong Lung Sing. At that hearing the father testified he had four sons. The court said:

"It may be true that false testimony was given by the father at the former hearings in his efforts to obtain the entry of his sons but, assuming such to have been the fact, it would not justify exclusion in this instance if there is some evidence to satisfy a reasonable mind that the relator, claiming rights of American citizenship through the nativity of his father, was entitled thereto."

This case quotes *ex parte Ng Bin Fong*, 20 F. 2d 1014, and *Go Lun v. Nagle*, CCA 9, 34 F. 2d 848, wherein the court, among other things, stated:

"The purpose of the hearing is to inquire into the citizenship of the applicant, not to develop discrepancies which may support an order of exclusion, regardless of the question of citizenship."

### ISSUE NO. 3

We direct attention to the statement made in appellee's brief (p. 6) as follows:

"While the testimony of appellant contained in Exhibit 7 to the effect that he was the blood son of Louie Foo, and Louie Foo, at the trial of this cause, gave similar testimony (Tr. 37), *all of which was uncontradicted*, the court below was not required nor did he believe such evidence, nor did he accept it as true." (*Italics ours.*)

At the trial of this case appellant objected to Exhibit No. 14 and that part of Exhibit No. 7 consisting of the testimony taken of appellant and his mother, Ng Shee, in Hong Kong (Tr. p. 46). In this connection appellee states in his brief (p. 5) as follows:

"In rendering his opinion, the court apparently considered all of this record in its entirety, except the questions and answers propounded to plaintiff's alleged mother, Ng Shee. This questioning was determined by the court below to be inadmissible under the rule of *Wong Wing Foo v. McGrath*, 9 Cir. 1952, 196 F. 2d 120."

In the opinion the trial court (Tr. 15) says:

"I have refrained from considering any portion of the Immigration and Naturalization Service files, except for statements made by the plaintiff and documents submitted either by him or on his behalf."

Notwithstanding the above remarks of the trial court just quoted, it is apparent that he did consider the testimony of the mother, Ng Shee, where the court states in his opinion as follows (Tr. 15):

"The only evidence of plaintiff's identity was supplied by his alleged mother and himself in interviews conducted by the Hong Kong Consulate in connection with plaintiff's application for a passport and which are a part of the Immigration and Naturalization file pertaining to plaintiff. They contradicted each other on many facts which should have been common knowledge to both of them. All of this appeared in the questions propounded to plaintiff in the presence of his alleged mother."

It is apparent that the trial court did, in fact, consider the said incompetent and prejudicial evidence in his decision.

## CONCLUSION

It is submitted that, from all the evidence in this case, the relationship of father and son has been established between Louie Foo and Louie Hoy Gay, which evidence was uncontradicted by appellee.

It is further submitted that, from all the evidence, Louie Foo is a citizen of the United States.

It is further submitted that the Court erred in admitting into evidence certain documents and testimony previously referred to.

It is further submitted that the Findings and Judgment of the lower court are clearly erroneous and that the judgment therein should be reversed and that appellant be declared to be a United States citizen and/or national.

Dated at Portland, Oregon, May 6, 1957.

BANKS & BANKS,  
By W. W. BANKS,

Attorneys for Appellant.















